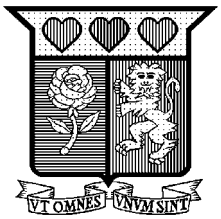
AUDITING AND INVESTIGATION

SUBJECT NO. 17

Revision Kit



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We would also like to extend our sincere gratitude and deep appreciation to **Dr. Benedict Maungu** for generously giving his time, expertise valuable contribution and skilfully co-ordinated the detailed effort of reviewing this revision -kit.

He holds the following academic honours, **Bachelor of Medicine and Bachelor of Surgery (MBChB), University of Nairobi and CPA (K)**. He is a lecturer at Strathmore University, School of Accountancy. He has generously given his time and expertise and skilfully co-ordinated the detailed effort of reviewing this revision kit.

CONTENTS

ACKNOWLEDGMENT ..... **ii**

PART I: INTRODUCTION ..... **iv**

Approach to Examinations v

SYLLABUS vi

PAPER NO. 17. AUDITING AND INVESTIGATIONS ..... **vi**

Topical Guide to Past Paper Questions viii

PART II: PAST PAPER QUESTIONS AND ANSWERS **1**

QUESTIONS – PAST PAPERS 1

ANSWERS – PAST PAPERS 47

PART III COMPREHENSIVE MOCK EXAMINATION **162**

QUESTIONS - MOCKS 162

ANSWERS – MOCKS 182

PART IV: REVISION QUESTIONS AND ANSWERS **243**

QUESTIONS 243

ANSWERS 254

PART I: INTRODUCTION

This revision kit addresses needs of students preparing to sit CPA Section 6 examination for Paper No.17 Auditing and Investigation.

The kit is divided into FOUR main parts:

Part I: INTRODUCTION

- Approach to Examinations
- Syllabus
- Topical guide to CPA past paper questions

Part II: PAST PAPER QUESTIONS AND ANSWERS

This Part contains KASNEB Past Papers with model suggested solutions between December 2000 and June 2000.

Part III: COMPREHENSIVE MOCK EXAMINATION PAPERS WITH SAMPLE ANSWERS

PART IV: REVISION QUESTIONS AND ANSWERS

To make effective use of this kit, candidates are advised to:

- Read widely some of the books suggested in the reading list so as to have adequate background information relating to the issues raised in the revision questions.
- Do the MOCK papers in part III under exam conditions and then check the solutions provided to assess their success in tackling the questions

Given adequate and focussed preparation, this kit should be useful in enabling any student preparing for examinations in Auditing and related courses to pass with good grades in the exams

APPROACH TO EXAMINATIONS

Experience in marking auditing examinations suggests that failure to answer all the questions and poor expression are every bit as frequent causes of failure as lack of knowledge. Lack of knowledge necessitates more learning, but the two other problems may not be so easily solved. They are essentially inter-related, and while not exclusive to auditing they are perhaps more apparent in this subject. So the following ideas may help you to give your best performance 'on the day'.

Remember that you gain most marks by citing the main concepts in response to a question. You gain little by going into immense detail. So it follows that you can score relatively the most marks in the first few minutes of your answer attempts – provided that you know the main concepts. And if you do not, then the examiner will not be impressed by a profusion of irrelevant detail. Indeed he may become annoyed, and this may cloud his view as to the rest of your paper. Examiners are only human (nearly!) remember.

To ensure that you have the opportunity of scoring on all the questions you must answer all of them! Even if you can produce four perfect answers five adequate ones will normally score better. And perfect auditing answers are very rare. So it is essential to divide your time up equally between the questions leaving a bit over for reading and review time. Be ruthless about the cut-off time. For if you creep over on your first few answers you risk having too little time for even the main concepts in your final answer.

Auditing answers require planning and a structure. Without this, expression will invariably be poor. And the introduction of unnecessary detail often makes matters worse. So concentrate on quality rather than quantity. And quality must apply to both your written English, which should be a professional style (it is after all a professional examination), and to your handwriting. Examiners try to decipher the indecipherable (usually), but the temptation to put a large cross through illegible work is very strong at the end of a long marking session.

Answer the question is an obvious point, which applies to any examination. But it is amazing how many candidates do not. So you must read the question carefully – perhaps once quickly through the complete paper to gather the main topics from each question, and then again in more detail to ensure that you have a proper understanding before you commence your answers. Then give your answer in the form that is required. For example, if a letter is asked for, give your answer in letter format. You will lose marks for an essay.

Examiners regretfully do not always supply perfect questions so if you find one that is ambiguous, choose another one if possible; but if not possible then state your assumptions and proceed logically from there. Even if the examiner disagrees with your assumptions, he should award marks for a logical, practical exposure. But he may not, just as he may not award marks if you are highly critical (of his opinions) in a question involving a controversial issue. So I would avoid such questions also, but if you cannot avoid them, ensure that you put both sides of the debate, and do not state your opinions in too forceful a manner. Where you are expressing your own opinion (to which you are perfectly entitled), ensure that this is distinguished in your answer from where you cite the opinions of others, or rely on recognized publications.

The auditing syllabus is large. And becomes larger with each new Auditing Standard and Accounting Statement. Questions are now being written much more imaginatively than in the past, and often test several aspects of the syllabus in just one question. An analysis of past papers will reveal certain aspects of the syllabus which examiners (rightly) concentrate upon (for example, stock, debtors and computers). While it is highly dangerous to 'question spot' to the extent that your preparation for the examination involves only five topics, it is common sense to pay particular attention to those topics that are frequently examined.

Good luck!

SYLLABUS

PAPER NO. 17. AUDITING AND INVESTIGATIONS

OBJECTIVE

To ensure that the candidate has competence in the auditing of public and private institutions and to carry out audit investigations.

SPECIFIC OBJECTIVES

A candidate who passes this subject should be able to:

- Describe the professional and legal framework within which auditing is practiced
- Plan and execute all types of audits
- Prepare and analyze comprehensive audit reports
- Prepare all specialized reports required of an accountant.

CONTENT

Professional and Legal Development

- Accounting standards and the auditor
- Audit standards and guidelines, comments and review
- Auditors professional ethics and disciplinary procedures
- Auditor's independence
- Legal liability of auditors.
- Structure of audit reports
- The cost-benefit analysis of an audit
- Auditing beyond the financial statements

Controls and Monitoring Systems

- Controls and the development of computer technology;
- Impact of development in information technology on the auditor, auditing techniques, controls within a computerized accounting system
- The utilization of an internal audit department
- Audit committees
- Impact of controls and information technology on sufficiency, relevance and reliability of audit evidence.

Auditing of Financial Statements

- Sampling and risk assessment of evidence from financial statements
- Audit of assets, liabilities and equities
- Audit of profit and loss items
- Audit of group accounts
- Post balance sheet audits.
- Audit Approach of Specialised Organizations
- Banks, financial institutions, building societies, insurance companies and hire-purchase companies
- Charities and no-profit making organizations
- Co-operative societies, public authorities and local authorities
- Small businesses' audits
- Pension schemes

Accounting Reports

- Unaudited financial statements
- Reports on prospectuses
- Interim and proforma financial statements
- Tax certificates

Audit Investigations

- Meaning and importance of audit investigations
- Types: Interest acquisition audits; Fraud and error investigations; Management audits; Professional tasks undertaken on behalf of statutory authorities such as Registrar of Companies, Controller and Auditor General and Auditor General
- (Corporations).

Receivership and Liquidations

- Auditors responsibility in receiverships and liquidations
- Structure and contents of reports
- Ethical issues in receivership and liquidations.

Topical Guide to Past Paper Questions

Below is an outline of the major topics of the syllabus and an assortment of questions that have featured in the past CPA examinations. The questions and answers are provided in PART II of the Kit. With respective page numbers to aid reference.

SITTING	QN	TOPIC	QUESTION	ANSWER
June 2000	1	IFRS adoption		
	2	Audit strategy		
	3	Review and evaluation of audit work		
	4	Impact and processing controls in a computerized environment		
	5	Investigations and review of financial statements		
July 2000	1	Topical issues and developments in auditing		
	2	Computerised auditing terminologies		
	3	Risk based auditing		
	4	Fraud investigations		
	5	Audit responsibilities in a receivership		
Dec 2000	1	Controls in a computerized auditing environment		
	2	Professional ethics, illegal payments		
	3	Fraud, ethics, review of financial statements		
	4	Insurance claims		
	5	Corporate governance/audit committees		
June 2001	1	Management letters/Internal control		
	2	Provision, impairment of assets		
	3	Leasehold assets		
	4	Audit of Group Accounts		
	5	Subsequent events		
Dec 2001	1	Risk based auditing		

SITTING	QN	TOPIC	QUESTION	ANSWER
	2	IFRSs and auditor negligence		
	3	Pension plans		
	4	Purchase of computer systems and impact of computerization on auditing		
	5	Audit, risk, ethics and opinion shopping		
June 2002	1	Internal control		
	2	Going concern		
	3	Investigations		
	4	Advantages of computerization		
	5	Topical issues and auditor negligence		
Dec 2002	1	Verification and internal controls		
	2	Provisions and auditor negligence		
	3	Subsequent events		
	4	Inventory valuation, depreciation, contingent liabilities		
	5	Topical issues and developments		
June 2003	1	Prospective financial information		
	2	Management letters		
	3	Analytical review		
	4	Revenue recognition		
	5	Internal controls		
Dec 2003	1	Audit planning		
	2	Internal controls		
	3	Provisions		
	4	Creative/aggressive accounting		
	5	Fraud and ethical considerations		

June 2004	1	Internal controls – wages		
	2	Audit risk and strategy		
	3	Audit of stocks		
	4	Fraud		
	5	Receivership and personal liability		
Dec 2004	1	Internal controls in a network environment		
	2	Audit planning		
	3	Going concern		
	4	Corporate governance/auditor negligence		
	5	Current issues		
June 2005	1	Audit planning		
	2	Assurance engagements		
	3	Prospective financial information and fraud		
	4	Related party transactions, Group audits		
	5	Internal audit		
Dec 2005	1	Computerised auditing		
	2	Assurance engagements		
	3	Substantive procedures		
	4	Audit planning		
	5	Responsibility for financial statements, audit limitations and judgements		

PART II: PAST PAPER QUESTIONS AND ANSWERS

QUESTIONS – PAST PAPERS

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD
CPA PART III
AUDITING AND INVESTIGATION

JUNE 2000

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

The Institute of Certified Public Accountants of Kenya has opted for the adoption of International Accounting Standards for all the companies with financial year beginning on or after 1 January 1999. In 1999, some companies opted for an early adoption of the International Accounting Standards. Some companies whose financial year end was 31 December 1999 have already adopted the standards.

Required:

Outline the major changes that have been necessitated by the adoption of International Accounting Standards. **(Total: 16 marks)**

QUESTION TWO

The opportunity has arisen for your firm to seek appointment as auditors of Supersave Ltd., a supermarket chain of 20 stores which operates a sophisticated computerized stock control and re-ordering system. You learn that Supersave Ltd. has also invited three of your competitors to produce a written presentation, the standard of which is crucial to progressing to the next stage when the company will select two firms to make an oral presentation. Given the complex systems within its business, Supersave Ltd. is particularly anxious to establish the ability of your auditing procedures to deal with the business risks and has asked you to set out as part of your presentation your approach concerning:
audit risk that is, the degree of misstatement through errors or irregularities and how your procedures would seek to address it in the business of Supersave Ltd.
Materiality and how this might be applied
sampling and the extent to which it might be appropriate to use this technique
analytical review and its contribution to the efficiency of your audit process.

You understand the need for Supersave Ltd. to have a high level of confidence in your firm's approach to highly computerized clients, and you have the task of drafting the sections of your firm's written presentation to demonstrate how your procedures would be likely to apply to this client.

Required

Draft the section of the written presentation to Supersave Ltd. which deals with these four separate aspects of the audit approach. **(Total: 24 marks)**

QUESTION THREE

Vintage Villas Ltd. operates five holiday centers on freehold sites in Kenya. The company's financial statements for the year ended 30 April 2000 disclose total turnover of 456 million and net profit before taxation of Sh.50,400,000. The following matters have arisen for your audit work on these financial statements:

Costs of brochures and advertising of Sh.15,840,000 relating to the year ended 30 April 2000 for the peak season have been carried forward in the balance sheet as a prepayment.

Bar stocks at one of the holiday centers were not physically counted on 30 April 2000 but were estimated by the bar manager at Sh.840,000 based on the previous physical stocktaking at 31 March 2000 which disclosed a value of Sh.768,000. Sales during the month of April amounted to Sh.1,320,000. The subsequent physical stocktaking took place on 31 May 2000. using the estimated value on 30 April 2000, a review of the trading results for the month of April and May disclosed a gross profit percentage of 60% and 39% respectively, compared with an average of 46% for the other eleven months of the year.

The manger of each holiday center is responsible for paying casual labour employed during the six peak holiday weeks and for the shorter periods at other times of the year. These payments are made in cash and amount to approximately Sh.4,800,000 per center for the year, but no receipts or vouchers are available apart from the weekly lists of payments signed by each manager. However all necessary PAYE and NSSF requirements have been complied with in respect of such payments.

Provisions for liabilities and charges include a provision for future maintenance of Sh.24,000,000 representing one third of the estimated cost of totally renovating all building in the holiday centers. During February each year, one third of the properties on each side is fully renovated.

Required:

Comment on the further considerations required of each of the above matters in order to conclude the audit and to indicate the possible effects on the audit report.

(Total: 20 marks)

QUESTION FOUR

Consumer Supplies Ltd. which has an annual turnover of approximately Sh.1,500 million maintains a computerized sales ledger for approximately 6,000 customers. The existing computer system is prone to input and processing errors due to insufficient controls being incorporated into the programs. Consequently the programs are to be rewritten.

Required:

Describe in note form the controls which could be written into the new program in order to minimize the occurrence of input and processing errors. **(Total: 20 marks)**

QUESTION FIVE

Mr. Kimani and Mr. Mathenge are each 50% shareholders and the only directors of K&M Ltd., a company which operates as a building contractor involved in civil engineering contracts which frequently take more than one year to complete. The turnover of the company in the year ended 31 March 2000 was in the region of Sh.1,200 million. The company has been suffering cash flow problems in recent times. Mr. Kimani and Mr. Mathenge have disagreed on the management policies of the company. As a result of this disagreement, Mr. Mathenge has agreed to sell his shares to Mr. Kimani and has resigned as a director with effect from 31 March 2000. The consideration for the shares is to be fixed by a valuation of the shares based on the audited accounts for the year ended 31 March 2000.

You have been appointed the investigating accountant to review the valuation of the shares. Mr. Kimani and the auditors of K&M Ltd. have agreed to cooperate fully.

Required:

As the investigating accountant, detail those matters which you would pay particular attention to in carrying out your review. **(Total: 20 marks)**

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

YEAR 2000 SYLLABUSS - PILOT PAPER
CPA PART III
AUDITING AND INVESTIGATIONS

JULY 2000

QUESTION ONE

Public attention has been focused on Corporate Governance (the action, manner and system of governing) and especially the financial aspects for reasons including.

1. The collapse of many large companies without warning.
2. Concern about standards of financial reporting, where companies especially banks have in the past carried large amounts of non-performing debtors as good debtors.
3. Lack of accountability due to the companies being run by dominant characters.
4. Raids on company pension schemes by companies in financial difficulties.
5. Apparently excessive directors pay, the rates of which seem to be fixed by the recipients themselves.
6. Some notable frauds and incidents of insider trading.
7. A feeling threat auditors are too close to their clients and as a result not carrying out effective audit work.
8. Looseness of accounting standards.
9. The practice of opinion shopping where companies allegedly seek auditors who will agree with them.
10. The expectations gap which the investing public does not understand the rather limited role of the auditor. The public expects that the auditor should go beyond the law and practice especially in the area of fraud and future financial inability.

Required:

Discuss and make reasoned suggestions on the possible steps that organizations and the accounting profession can take to address the above concerns. **(Total: 20 marks)**

QUESTION TWO

The following quotations are extracted from the International standards of auditing in a computer information systems environment.

1. Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form, where a complete application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an applications, program logic may be difficult to detect on a timely basis by manual (user) procedure.
2. Many control procedures that would ordinarily be performed by separate individuals in manual systems may be concentrated in computer information systems. Thus, as an individual who has access to computer programs. Processing of date may be in a position to perform incompatible functions.
3. The case of processing and analyzing large quantities of data using computer may provided by the auditor with opportunities to apply general or specialize computer audit techniques and tools in the execution of audit tests.

4. The auditor would have sufficient knowledge of the computer information systems to plan, direct, supervise and review the work performed. The auditor should consider whether specialized computer information systems skills are needed in an audit. These may be needed to.

Obtain sufficient understanding of the accounting and internal control system affected by the computer information systems environment.
Design and perform appropriate tests of control and substantive procedures.

Required:

(a) Explain each of the phrases, a computer transaction trail and errors embedded referred to above and state in respect of each an example of the way in which the auditor might attempt to overcome the problems in stock control systems arising from these two possibilities. (6 marks)
(b) Briefly outline the important aspects of segregation of functions that become necessary in computer information systems particularly a large organization with a centralized computer-based accounting system. (4 marks)
(c) Briefly state two computer assisted audit techniques (CAATS), which the auditor can use in the audit of the above case. (4 marks)
(d) Explain the words "tests of control", "application control" and "general control" in the computer audit context. Illustrate your answer by obtaining one relevant test of control on"
   (i) An application control: and
   (ii) A general control (6 marks)

(Total: 20 marks)

QUESTION THREE

Modern approach to auditing called risk-based auditing is a most welcome development.

Required:

(a) Define the term risk-based auditing. (3 marks)
(b) Explain what is meant by the terms:

   (i) Inherent risk
   (ii) Control risk
   (iii) Detection risk (3 marks)

(c) List the factors, which the auditors should bear in mind when assessing the inherent risk and control risk (audit risk) of a company). (6 marks)
(d) Explain why there has been an increased use of risk-based auditing approach in recent years and what advantages for the auditors from the adoption of such an approach. (4 marks)
(e) Risk-based auditing is often associated with the use of statistical sampling techniques in auditing. Explain why the risk based auditing and statistical sampling techniques are associated. Give an illustration of the circumstances under which statistical sampling techniques are either appropriate or not appropriately associated to risk based auditing. (4 marks)

(Total: 20 marks)

QUESTION FOUR

(a) List ten stages of fraud investigations` (5 marks)
(b) ushirika hardware is a small wholesale firm dealing in hardware items. You have just received a telephone call from the owner manager telling you that his cashier who is also the bookkeeper was responsible for the receipt and payment of cash and the

payment of wages has not reported to work for the last three days. During the discussion the owner manager informs you that he suspects some irregularities with regard to both the receipt and payments of cash.

Required:

Tabulate a programme for investigation of the possibility and extent of any defalculation of cash that may have taken place. (15 marks)

(Total: 20 marks)

QUESTION FIVE

Nyama Safi Company has been in operation since early 1970s buying live animals for slaughter and sale of meat and meat products. Due to stiff competition from small and medium meat companies, the company experienced loses. In December 1999 a receiver was appointed by a creditor under powers in a loan agreement, which gave a floating charge. A resolution to wind up the company voluntarily was passed on 10 January 2000, when the liquidator was appointed.

You were subsequently appointed to audit the liquidation and receivership accounts mainly the receiver's and liquidators statements of accounts

You have discovered that:

1. Assets were sold at below market value through an appointed auctioneer. The auction firm belongs to the wife of one of the directors of Nyama Safi Company.
2. A year ago, some of the assets, mainly Mercedes Benz and Pajero cars, were sold to the directors at net book values, which were much below the realizable market values.

Required:

(a) State your audit responsibilities in the audit of liquidation and receivership. (10 marks)
(b) Indicate the action you would take to verify the values of the assets in the cases above (10 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATION

DECEMBER 2000

Answer All questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

Your firm is the auditor of Nairobi Special Supermarket Ltd. which sells a variety of goods to the general public from a single retail supermarket shop. The company has recently installed a bar coding system for recording the movement of stock sales and purchases.

The system comprises:
A main computer located in the offices above the shop, where all the standing and transaction data are held.
Details of goods received are entered into the computer by the goods received department. Normally, the items are identified by scanning the bar code on the box containing the products, and the quantity of the items in the box is input manually.
Cash check pouts which:
read the bar code on the product and identify it
read the goods being sold
reduce the stock by the quantities being sold
include a description of the item and the selling price on the customer's bill
record the total sum owed by the customer and the payment received. Payment can be made by cash, cheque or credit card.
The accounts office can change the selling price of the products, which are recorded on the computer's standing data file. The systems records purchase prices from purchase invoices.
The system allows the addition of new products namely, bar code number, description, selling price and purchase price, amendment of details of existing products and deletion of products the company has discontinued.
Stock quantities on the computer can be amended manually.
The managing director of Nairobi Special Supermarket Ltd. has asked your advice on the controls which should be established to ensure that the system provides reliable information. You will use information provided by the system, including stock levels and sales in your audit of the company's accounts.

Required:
Describe the controls which should be in operation in this computer system in order to:
minimize the risk of failure or breakdown of the system. Your answer should include consideration of measure to minimize the delay between the breakdown and the time when the system is operating satisfactorily again.
Ensure that product details on the computer's standing data file are correct over the addition, amendment and deletion of product details.
Ensure that the selling prices of the company's products on the computer's standing data file are correct and the same as those on the shelves and racks containing the products in the shop.
Ensure that the quantities of stock recorded by the computer accurately reflect the actual stock in the shop. (7 marks)

(Total: 25 marks)

QUESTION TWO

Rural and Urban Housing Ltd. is a large company whose main activities relate to the house building market. Your firm has audited Rural and Urban Housing Ltd. for several years. During the audit for the year ended 30 September 2000, the audit manager has come across two items that he feels require discussing with the audit engagement partner. Details of the relevant items are:

During statistical testing of delivery notes, an observant audit assistant had noticed that the delivery address of several items of purchase materials was that of the managing director. Using the costing records, these materials were traced to job spoo-l which was the construction of a swimming pool. No sales invoice had been raised for this job. On investigation the audit manager discovered that the job as the construction of a 'demonstration' swimming pool which prospective purchasers could view. It has been included in Rural and Urban Housing Ltd.'s balance sheet as a fixed asset. The maintenance and running costs of the pool have been charged to the profit and loss account as promotion and selling costs.

Several large payments have been made to unidentified agents and described as commissions in respect of obtaining building contracts. Most of these payments have been made in cash, some of which were in foreign currencies, however, some payments have been made by cheque. Enquiries relating to the payee of the cheques have revealed that they are in the name of a nominee and the beneficiary cannot be identified. There is no supporting documentation for any of the payments. The finance director of Rural and Urban Housing Ltd. Has said that such commissions are common practice and the agents represent valuable contracts whose identity must be kept confidential as otherwise Rural and Urban Housing Ltd.'s competitors would be able to 'poach' work from them.

Required:

As the engagement partner for the audit of Rural and Urban Housing Ltd., discuss the matters you would consider including any further inquiries you would make, in determining the appropriate treatment of:

a) job spoo-1; (7 marks)

b) the payments of the commissions (8 marks)

(Total: 15 marks)

QUESTION THREE

Commercial Sales Ltd. was a growth-oriented company that was dominated by its managing director, Mr. A Chongo. The company sold quantity music systems direct to the public. A large number of sales person were employed on a commission only basis. The music systems were sent to the sales agents who then sold them direct to the public using telephones sales techniques. The music systems were sent to the sales agents on a sale or return basis and commercial sales ltd. recognized the sale of the equipment when it was received by the sales agents. Any returns of the music systems were treated as repurchases in the period concerned.

The company enjoyed a tremendous growth record. The main reasons for this expansion were as follows:

Mr. A Chongo falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the company's turnover.

At the year end, Mr. Chongo dispatched nearly all of his stock of music systems to the sales agents and repurchased those that they wished to return after the year end.

Twenty percent of the cost of sales were capitalized. This was achieved by the falsification of purchase invoices with the co-operation of the supplier company. Suppliers furnished the company with invoices for fixed assets but supplied music systems.

The directors of the company enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries. The directors did not query the

unusually rapid growth of the company and were unaware of the fraud perpetrated by Mr. A Chongo.

Mr. A Chongo spent large sums of money in creating false records and bribing accomplices in order to conceal the fraud from the auditors. He insisted that the auditors should sign a 'confidentiality' agreement which effectively precluded the auditors from corroborating sales with independent third parties and from examining the service contracts of the directors. This agreement had the effect of preventing the auditors from discussing the affairs of the company with the sales agents.

The fraud was discovered when a disgruntled director wrote an anonymous letter to the Nairobi Stock Exchange concerning the reasons for Commercial Sales Ltd.'s growth. The auditors were subsequently sued by a major bank that had granted a loan to Commercial Sales Ltd. on the basis of interim accounts. These accounts had been reviewed by the auditors and a review report issued.

Required:

a) Explain the key audit tests would normally ensure that such a fraud as that perpetrated by Mr. A Chongo would be detected. (7 marks)
b) Discuss the implications of the signing of the 'confidentiality' agreement by the auditors. (4 marks)
c) Explain how the 'review report' issued by the auditors on the interim financial statement differs of its level of assurance from the auditors' report on the year end financial statements. (4 marks)
d) Discuss whether you think that the auditor is guilty of professional negligence in not detecting the fraud. (5 marks)

(Total: 20 marks)

QUESTION FOUR

Omega Furniture Ltd. is an audit client of Omega firm. It manufactures household furniture. It has a year-end of 31 December. On 13 June 2000, a fire destroyed the company's factory complex, which included the area used for storing raw materials. The fire was caused by an electrical fault. The factory has now been rebuilt and the company commenced trading again in November 2000.
The finance director of Omega Furniture Ltd. produces monthly management accounts; in these stocks and cost of sales are estimated, based on sales figures less assumed margins. On 321 March and 30 September, the company conducts full stocktakes for its own purposes in addition to is year end stock count. The results of these stock counts are compared with the management accounts for March and September and adjustments are made to reflect the physical stock quantities and their appropriate values.

The finance director has contacted your firm to provide a certificate in support of his claim for loss of profits and loss of stocks arising as a result of the fire.

Required:

a) State what information you would seek and what procedures you would perform to reach an opinion on the company's claim for loss of profits and loss of stocks. (12 marks)
b) Assuming you obtain all the information you require, draft your special report. Give brief reasons for the form of wording you have adopted. (8 marks)

(Total: 20 marks)

QUESTION FIVE

In an attempt to improve Corporate Governance of companies in Kenya banks and listed companies are now required to have audit committees.

Explain the composition and the role of audit committees and offer suggestions as to how their role can be strengthened. **(Total: 20 marks)**

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPS PART III

AUDITING AND INVESTIGATIONS

JUNE 2001.

QUESTION ONE

Your firm is the auditor of Global foods ltd, which supplies a wide range of imported foods to supermarkets and stores from two large depots in Nairobi. The company employs 300 people and has a turnover of Sh 3 billion. The accounts department uses a maintenance computer for all the accounting records except for stock control, which is maintained manually on a card system at each depot. Deliveries are made to customers by the company's fleet of lorries and vans.

After ascertaining and recording the system of internal control you have decided that you wish to place reliance on the controls in many areas. The results of your substantive tests on the system of controls on purchases and stocks reveal that:

1. Out of 100 purchase invoices selected for inspection, 2 could not be found and 2 were not initialed as checked and approved for payment.
2. Out of 120 stock cards inspected, 4 contained an instance where the delivered quantity had been altered by a significant amount.
3. One supplier is regularly paid before supplies are delivered on the basis of pro forma invoices, which are processed through the purchase ledger system on receipt so as to initiate the necessary payments.

No other exceptions were noted.

Required:

(a) Specify what further procedures you would adopt in order to be able to reach a conclusion on whether the company's system of control can be relied upon, indicating what factors you would consider in reaching your conclusion. (14 marks)

(b) State the reasons why you would report to management, in writing, significant weakness in internal control and the principal limitations on the use of such a report. (6 marks)

(Total: 20 marks)

QUESTION TWO

You are the auditor of Nairobi Motor spares ltd, a private company which wholesales parts for cars and vans. You have completed the fieldwork for the year ended 30 April 2001 and have identified the following three outstanding issues.

1. Nakuru Motor Spares Ltd has been a customer of Nairobi Motor Spares Ltd. At 30 April 2000, the previous year-end, the amount due from Nakuru Motor Spares Ltd was Sh 22,400,000 out of total trade debtors of Sh 145,600,000. Nakuru Motor Spares Ltd is slow payer but places frequent orders with Nairobi Motor Spares Ltd. Although the amounts due at 30 April 2002 were settled in the year to 30 April 2001, further supplies have increased the balance on Nakuru Motor Spares ltd's account to Sh 35,840,000 at 30 April 2001. Nairobi Motor Spares ltd informs you that it has recently obtained a floating charge on the stock of Nakuru Motor Spares ltd and the client therefore believes no provision is required at 30 April 2001.

On comparison of the physical count with computerized book stock records at 30 April, many individual unders and overs have been identified, some of which are large in terms of quantities and values. The client has explained, that because there are several thousand limes and many parts are similar in description and size, mistakes easily occur and the unders and overs are, therefore, the result of errors in description or categorization. Accordingly, the client is satisfied that this is not a matter of concern and proposes to make adjustment to the book stock figure.

3. Stock has risen substantially over the 12 months to 30 April 2001 and the client is unable to provide a satisfactory overall explanation. An analysis of the increase would require an extensive line-by-line review, which the client is unwilling to do because of the number of lines in stock. The managing director suggests that bulk-buying opportunities offered at attractive prices account for a good part of the stock increase. The client's computer system generates a document called an "old stock listing" which the audit staff has used to assess stock provisions. It is produced annually at the year-end by a special software routine. The old stock listing identifies only those stock lines not moving at all during the last six months of the year and shows a 25% increase on the previous year in the total value of such items. No further ageing information is produced. The client has based the stock provision on items included in the "old stock listing".

Required:

In respect of each of the above three issues, state what further evidence you would seek in order to reach a conclusion upon the accounting treatment to be adopted in the financial statements of Nairobi Motor Spares ltd at 30 April 2001. **(Total: 20 marks)**

QUESTION THREE

You are the auditor of a company whose year-end was 31 March 2001. The directors have decided to obtain a professional valuation of all the freehold and leasehold properties as at 31 March 2001 and to reflect this valuation in the accounts to 31 March 2001.

The following points are brought to your attention:
1. Depreciation has never been provided on freehold and long leasehold properties
2. One of the properties is wholly let out to third parties, and the directors intend to dispose of this property as soon as possible.

Required:

Set out the matters which, as a result of the property valuation, should be taken in consideration during the preparation of the accounts to 31 March 2001 and the disclosures, which should be made in the accounts for that year. **(Total: 20 marks)**

QUESTION FOUR

You are the auditor of a listed (quoted) company with diversified interests mainly of an industrial nature. One subsidiary, however, acquired on the first day of the financial year, is engaged in banking. The finance director has asked you to advise him as to the manner in which the banking subsidiary should be treated in the group accounts.

Required:

Write a formal letter to the finance director setting out the legal and accounting standards requirements appropriate to these circumstances **(Total: 20 marks)**

QUESTION FIVE

"The management letter is a form of report by external auditors to the management. This report which in some respects is a report on the ability and effectiveness of management is useful to shareholders as the financial statements and should be distributed to the shareholders not just to management themselves."

Required:

Discuss the merits and demerits of this proposition. How does it compare to the current practice? **(Total: 20 marks)**

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART 111

AUDITING AND INVESTIGATIONS

DECEMBER 2001

QUESTION ONE

Rural and Urban Housing Ltd is a large company whose main activities relate to the house building market. Your firm has audited Rural Urban Housing Ltd for several years. During the audit for the year ended 30 September, the audit manager has come across two items he feel require discussing with the audit engagement partner. Details of the relevant items are:

During statistical testing of delivery notes, an observant audit assistant had noticed that the delivery address of several items of purchased materials was that of the managing director. Using the costing records, these materials were traced to Job Spoo 1 which was the construction of a swimming pool. No sales invoice had been raised for this job. On investigation the audit manager discovered that the job was the construction of a "demonstration" swimming pool which prospective purchasers could view. It had been included in Rural and Urban Housing Ltd's balance sheet as a fixed asset. The maintenance and running costs of the pool have been charged to the profit and loss account as promotion and selling costs.
Several large payments have been made to unidentified agents and described as commissions in respect of obtaining building contracts. Most of these payments have been made in cash, some of which were in foreign currencies. However, the name of a nominee and the beneficiary cannot be identified. There is no supporting documentation for any of the payments. The finance director of Rural and Urban Housing Ltd has said that such commissions are common practice and the agents represent valuable contacts whose identity must be kept confidential as otherwise Rural and Urban Housing Ltd's competitors would be able to "poach" work from them.

Required:

As the engagement partner for the audit of Rural and Urban Housing Ltd, discuss the matters you would consider including any further inquiries you would make in determining the appropriate treatment of:

a) Job Spoo 1 (7 marks)
b) The payments of the commissions (8 marks)
(Total: 15 marks)

QUESTION TWO

Jos Enterprises ltd went into creditors' voluntary liquidation in February 2001 with total assets estimated to realize Sh 87 million and total estimated liabilities of Sh 10 million. The liquidator has recently commenced proceedings against the company's auditors for alleged negligence, and the auditor's advocates have approached you as an independent expert to advise on the auditor's position.

The last audited financial statements were for the period to 30 June 2000 and were signed by the auditors on 16 September 2000 without qualification. It is alleged that the financial statements, which showed fixed assets and deferred expenditure of Sh 22,425,000, current assets of Sh

84,410,000 and total liabilities of Sh 91,540,000, contained the following inaccuracies and omissions.

1. Improvements to lease hold premises, costing Sh 6,210,000 in July 1998, had been capitalized and were being amortized over the life of the 25-year lease. These premises were vacated in October 2000 and placed on the market. No tenant could be found and the liquidator ultimately surrendered the lease to the landlord.
2. Deferred expenditure in the balance sheet of Sh3, 910,000 represented the balance of pure and applied research and development costs incurred two years previously. It was to have been written off over the following eight years, being the remaining period estimated by the directors over which the relevant product was expected to be sold, although production of that product ceases in July 2000.
3. Credit notes totaling Sh 1,955,000 were raised in August, September and October 2000 in respect of sales of faulty goods to customers, which had been included in debtors at 30 June 2000 against which no provision had been made.
4. Prior to 30 June 2000, the company had guaranteed advances of Sh 7,017,000 by its bankers to another company also under the control of the directors. The bankers enforced the guarantee in January 2001. No mention of the guarantee was made in the financial statements.
5. In august 2000, the company implemented a decision to make more than half of the employees redundant, giving rise to redundancy payments of Sh 3,105,000, which were not provided for in the balance sheet as at 30 June 2000, but which were disclosed in notes to the financial statements.
6. Outgoings on entertaining and publicity costs had amounted to approximately Sh 3,450,000 per annum in recent years, and approximately 50% represented "reimbursements" from petty cash to each of the three directors for which no vouchers are available.

Before deciding whether or not to instruct you further, the advocates would like to discuss the foregoing information with you.

Your are required to prepare notes for a meeting with the auditors advocates

(a) Commenting on the treatment of each of the six matters with the financial statements (12 marks)

(b) Indicating whether or not the auditors may have been negligent (8 marks)

(Total: 20 marks)

Note:

In your answer, you are to assume that all the six matters were or would have been material to the company's financial statements for the year ended 30 June 2000.

QUESTION THREE

You are the auditor of LF Ltd, a large company which has for some years operated a defined benefit self-administered pension scheme for all employees. You are also the auditor of the pension scheme. The scheme carries out an actuarial valuation once every five years.

It has come to the directors of LF ltd attention that there is a substantial deficiency in the fund as at 31 October 2001, following the production of the latest actuarial report as at that date. The board is considering the following alternative courses of action, suggested by the actuary, to rectify the position:

1. To make an immediate specified lump sum payment to clear the deficiency.
2. To clear the deficiency by specified equal payments over the following five years.
3. To increase the employer's future contributions by a specified percentage

You are enquired to write a letter to the directors advising them on how each of the alternative methods listed above would match the requirement that the accounts show a true and fair view. In your letter, indicate whether such payments or contributions should be treated as normal, exceptional, extraordinary deferred or prior year items. Further, advise on any other matters they should bear in mind considering the three alternatives. **(Total: 20 marks)**

QUESTION FOUR

You have been the auditor of PJ Manufacturing Ltd for many years. The company is a small business with a turnover of Sh 400 million and fifty employees, which include three office staff. The audit for the year to 30 September 2001 has recently been completed and no serious problems arose.

During the post audit review meeting, Mr. PJ Shah, the Managing Director, tells you that in the coming year the company intends to purchase a personal computer (PC) system and an accounting software package. He has suggested that the company should first computerize the sales ledger system in order to gain experience and follow this with the purchases, wages and nominal ledger systems. All of the company's accounting records are expected to be computerized by 30 April 2002. Mr. PJ Shah has asked for your advice on the above and also on which hardware and software the company should purchase.

Required:

a) i. Discuss the matters Mr. PJ Shah should take into account when deciding to purchase a system such as described above. (6 marks)
ii. Discuss the major effects the computerization of PJ Manufacturing ltd accounting system will have on the planning of the audit for the year to 30 September 2002. (7 marks)

(b) Auditors of firms of all sizes, particularly those of large companies, have to be aware of the changes that advances in information technology are having on the audit environment.

Required:

Describe how developments in information technology are currently affecting auditing and their possible future impact. (7 marks)
(Total: 20 marks)

QUESTION FIVE

Twenty Second Century Ltd, a large company was founded and controlled by Mr. J.Presscot. The principal business of the company was to develop derelict land in city and town centers into office accommodation. In 1999, Kenya Revenue Authority became suspicious of the nature of the operations being carried out by the company and an investigation into its affairs commenced. The resultant report stated that the company's internal controls were weak and non-existent in many cases. The investigators found payments to unknown persons and fictious consultancy firms. In addition Mr. Prescott had maintained a secret expense account that was used to disburse funds to himself. The board of directors of Twenty Second Century Ltd did not know of the existence of this account. This expense account was maintained by the partner firm of accountants responsible for the audit of the company. The auditors were heavily criticized in the report of the investigators.

The firm of auditors A to Z & Co. had an aggressive marketing strategy and had increased its audit fees by 100% in two years. The audit firm had accepted the appointment in 1997 after the previous auditors had been dismissed. The audit report for the year ended 1996 had been heavily

qualified by the previous auditors on the grounds of poor internal control and lack of audit evidence. Mr. J.Presscot has approached several firms of auditors in order to ascertain whether they would qualify the audit report given the present systems of control in Twenty Second Century ltd. A to Z & co ltd has stated that it was unlikely they would qualify their report. They realized that Mr. J. Prescott was "opinion shopping" but were prepared to give an opinion in order to attract the client to the firm.

Twenty Second Century Ltd was subsequently put under receivership and liquidation and A to Z & Co were sued for negligence by the largest loan creditor, its bankers.

Required:

(a) Describe the procedures, which an audit firm should carry out before accepting a client with potentially high audit risk such as Twenty Second Century ltd (6 marks)
(b) Discuss the ethical problems raised by the maintenance of the secret expense account for Mr. J.Presscot by the audit partner. (5 marks)
(c) Suggest measures that audit firms might introduce to try and minimize the practice of "opinion shopping" by the prospective audit clients. (5 marks)
(d) Explain how audit firms can reduce the risk of litigation and its effects upon the audit practice (4 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATION

JUNE 2002

QUESTION ONE

You are the auditor of Fixit Ltd. The company consists of a head office and a chain of 200 shoe repair and key-cutting kiosks. These kiosks are located in supermarkets and shopping centers and each is run by a single staff member who repairs shoes and cuts keys while customers wait.

In an attempt to increase turnover, Fixit Ltd recently advertised that all workmanship in the kiosks would be guaranteed for three months. However, this additional service has not resulted in the expected additional sales. Management believe incremental revenue is being misappropriated by certain kiosk operators.

In addition, it has come to your attention that various components, namely heels, soles and keys are being removed from kiosks by certain operators and sold to competitors. Instances have also been found where operators regularly repair shoes for friends without charging them.

Although each kiosk has a register, controls and procedures in the chain are currently weak and head office management has asked for your advice on desirable internal control procedure.

Required:

Detail the internal control procedure you would expect to find that would provide adequate control over:
(a) Cash sales (10 marks)
(b) Stock (10 marks)
(Total 20 marks)

QUESTION TWO

(a) List the factors and explain reasons why these factors may indicate that a company may not be going concern
(b) Describe any further investigations you would carry out to decide:

(i) Whether the company is a going concern and
(ii) Whether it has a reasonable chance of recovering from the going concern problems.

Your answer should include details of checks you would carry out in verifying the company's profit and cash flow fore casts. (10 marks)
(Total 20 marks)

QUESTION THREE

John Mwangi has recently asked your firm's advice on whether to purchase Nathoo Merchants Ltd, which is a small builders' supply merchant. John Mwangi has previously been the proprietor of a small do-it-yourself business (which is a similar trade to the builders' supply merchant, but sells mainly to individuals), and he has recently been left a substantial sum of money on the death of his father.

Natho Merchants ltd sells:

1. Paint and decorating material
2. Hand tools and small electrical tools (for instance electric drills).
3. Electrical fittings, and
4. Building materials (bricks, wood, sand and cement).

The current owner of Nathoo Merchants ltd is retiring and is proposing to sell his business to John Mwangi. Nathoo Merchants ltd is financed by equity, bank loans and overdrafts. Their are no current accounts or loan accounts between the directors and the company.

The audited accounts of Nathoo Merchants ltd for the three years ended 30 April are available and John Mwangi has asked you to carry out an investigation into whether the accounts are reliable. The accounts of Nathoo Merchants ltd have been prepared by the auditor. From your knowledge of the auditor's reputation and the weakness in the system of internal control in Nathoo Merchants ltd, you believe there may be material errors in the accounts.

In the year ended 30 April 2002, Nathoo Merchants ltd had a turnover of 34 million. The company operates from its own freehold premises and it sells mainly to small builders and some individuals. Most of the sales are on credit but its sales to individuals are for cash. If he decides to purchase Nathoo Merchants ltd, John Mwangi plans to work full-time in the business.

Your are required to:

(a) List and briefly describe the investigations you would carry out in checking:
(i) The profit and loss accounts for the three years ended 30 April 2002. (7 marks)
(ii) The balance sheet as at 30 April 2002. (7 marks)

(b) List and briefly describe the factors you would consider in advising John Mwangi whether:

(i) To purchase all the shares in Nathoo Merchants ltd or (3 marks)
(ii) To purchase the assets, goodwill and liabilities from the company. Your answer should describe the factors, which you would consider in advising John Mwangi which assets and liabilities of Nathoo Merchants ltd he should purchase. (3 marks)

(Total 20 marks)

QUESTION FOUR

Your are the auditor of Modern supermarkets ltd, a company which operates a chain of 20 department stores in Nairobi and its environs, all of which are supplied by a central ware house. Each department store currently operates cash registers on which all sales are individually rung up by the cashier. Both cash and credit sales are made. The cash registers are all operated as stand-alone units and therefore provide no credit or stock control information.

Detailed stock records are currently not kept at the stores. Stock levels are monitored by means of periodic stock counts. Each store maintains its own debtors' records on a manual system.

Management is contemplating the conversion of the cash registers to IBM 4683 point-of-sale terminals, which will all be linked via a local area network at each store to an IBM personal computer AT/ Store controller. Each IBM 4683 point of sale terminal has a cash drawer with a standard lock and has the following capabilities:

Recording the point-of-sale transaction
Performing credit checks and checks on credit card validity
Providing price look-up and,

Printing a full description of each item purchased on the customer's receipt.

The new system will maintain stock, debtors and cash records. Each store will record stock receipts from the central warehouse and any other sundry stock movements using a terminal in the warehouse section of the store. Debtor's payments will be received by the accounting section of each store and recorded by means of a terminal situated in their office. This office will also be responsible for issuing credit notes and passing any sundry journals. The point-of-sale equipment will facilitate on-line update of debtors, stock and cash records.

The system will use standard bar coding on all products sold. For this purpose each point-of-sale terminal will be equipped with a flat-top scanner. Products purchased by the customer will be drawn over the scanner which will read the bar code. Product descriptions and prices will be read from the IBM store controller and printed on the tally slip. On-line diagnostics will constantly monitor the operation of the system and report errors.

All master file changes such as product and price changes, can only be made at the IBM store controller. All point-of-sale terminals are controlled from the IBM store controller. Reports such as till reconciliation's (cash, cheque, credit card and credit), bank deposit listings, sales analysis, debtor's listings and stock reports will be available on the system.

Each IBM store controller will in turn be linked via a modem and post office communications system to a computer at the head office. Consolidated information (total sales, cash, cheque, credit etc) from each store will be transmitted and processed to the general ledger on a daily basis and compared to the budget.

Required:

Discuss the advantages, which the company could expect to derive from the conversion from cash registers to point-of-sale terminals, including advantages both of general nature and in the specific areas of debtors, stock and cash. **(Total: 20 marks)**

QUESTION FIVE

With the recent ENRON debacle, the issue of auditors' liability has become even more topical. In this connection:

(a) List and briefly describe the circumstances when an auditor may be liable for damages for material misstatements in published accounts on which has expressed an audit opinion and the circumstances when he may avoid liability. (3 marks)

(b) List the persons who may make a successful legal claim against an auditor and state the basis a court of law would use to assess the value of damages. (4 marks)

(c) Briefly state the ways the liability of auditors could be limited and consider the practicality of these methods of limiting an auditor's liability. (3 marks)

(d) Consider the effect the limiting of an auditors liability is likely to have on:

(i) The investor's view of the reliability of the audit opinion: (2 marks)

(ii) The amount of work an auditor will perform (compared with the work he would perform if his liability was unlimited) and the effect this will have on the reliability of the audit opinion. (3 marks)

(e) Briefly come to a conclusion on:

(i) Whether you consider it practicable for an auditor's liability to be limited: (2 marks)

(ii) Whether limiting auditor's liability will affect the reliability of the audit opinion and (2 marks)

(iii) Whether you would agree with the proposal that an auditor's liability should be limited. (1 mark)

(Total: 20 marks

KENYA NATIONAL AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATIONS

DECEMBER 2002

QUESTION ONE

Your firm is the external auditor of Highland Tea Growers Company Ltd, one of the largest tea growing and manufacturing companies in Kenya and indeed, in Africa, Highland Tea Growers Company Ltd does not have an internal audit department.

At the interim audit you have been assigned to the audit of the wages system. This will involve obtaining an understanding of the wages system, testing the controls and performing substantive procedures in order to verify wages transactions.

The wages records are maintained on a computer and all the wages information is processed at the head office. Some of the employees are paid in cash and all other employees have their wages paid directly into their bank accounts.

Head office and manufacturing employees are paid their wages a week in arrears. All other employees are paid at the end of each week or month.

There is a personnel department, which is independent of the wages department. The personnel department maintains records of the employees including their start date, grade, current wage rate and leaving date (if appropriate.

Previous year's audits have revealed frauds by the wages department staff, which have been facilitated by weaknesses in controls in the wages system. These frauds have included:

1. Paying employees after appointment but before they commenced work.
2. Paying employees after they have left employment, and
3. Paying fictitious employees.

A check of current controls in the wages system has revealed that the company has failed to institute controls to prevent these types of fraud recurring. So the audit programme requires extensive substantive procedures to be carried out to ensure that recorded wages transitions have not been mis-stated by similar frauds taking place in the current year.

The existence of employees at the head office site can be verified by physical inspection. From a cost effectiveness point of view, only a small sample of plantations will be visited. The audit manager has asked you to consider the audit procedures you would carry out to obtain sufficient and appropriate evidence of the existence of employees at the plantations not visited by the audit staff.

The audit manager has explained that "unclaimed wages" (in part (c) below) arise when employees are not present to collect their wages at the time of payment. The unclaimed wage packets are given to the cashier who records their details in the unclaimed wages book and is responsible for their custody. Any employees who have not received his/her wage packet at the payout can obtain it from the cashier. You have ascertained that there is no system of checking the operation of the unclaimed wages system by a person independent of the cashier and the wages department.

You are required to describe:

(a) How you would verify that employees are not paid before they have commenced employment or after they have left (a starters and leavers test). (5marks)
(b) The audit procedures you would carry out in connection with attending a payout of wages in cash to the employees. (5 marks)
(c) The substantive checks of transactions you would carry out on the unclaimed wages system. (5 marks)
(d) The evidence you would obtain to verify the existence of employees whose wages are paid directly into their bank accounts. (5 marks)

(Total: 20 marks)

QUESTION TWO

You are the audit manager on the audit of Super Furniture Ltd a company which manufactures office and household furniture. The financial year-end of the company is 30 June 2002 and you took charge of the audit assignment on 20 august 2002 after the resignation of the previous audit manager.

The following are extracts from the audit-planning memorandum.

(a) Shareholdings

Currently all shares are held by the directors. A takeover offer has been received from Dominant Furniture Ltd, a listed company to buy 51% of the equity shares in Super Furniture Ltd. Negotiations are still under way.

(b) Materialiality

The materiality level has been set at Sh 1.5 million.

While reviewing the audit working papers for the year ended 30 June 2002, you find the following notes prepared by the senior in charge of the audit.

	2002	**2001**
	Sh. 000	**Sh. 000**
1. Sundry accruals	3,774	5,028
2. Provision of leave pay	1800	6,180
3. Provision for major maintenance	7954	12,000
4. Provision for legal costs	480	-
5. Provision for losses on insurance claims	-	1,050
6. Provision for credit notes	750	750
7. Provision for management and provisions	1,800	2,245
Total sundry accruals and provisions	16,558	27,253

Notes

1. Sundry accruals
For a full list of accruals see working paper H2.1. Supporting documentation has been seen for all accrued amounts over Sh 60,000 totaling Sh.2, 565.000 (68%). All accruals are for normal expenses of the company and appears to be reasonable.

2. Provision for leave pay

   `This amount agrees with the total leave pay due as reflected on the printout from the salaries system. We have reviewed the controls in the salaries system, including the computerized leave records and have tested the controls through compliance testing. No weaknesses or exceptions have been found.
   The reason for the lower provision is that the company has changed its leave policy. From 30 April 2002, only management may carry forward leave due to them from one year to the next. I have discussed and confirmed the new policy with Mr. Chege the financial director.

3. Provision for major maintenance

   The only movement on this account during the year has been maintenance expenses of Sh 4,046,000 debited against the account. I have seen supporting documentation for expenses totaling Sh 850,000 (being 21% of Sh 4,046,000.

4. Provision for legal costs

   This amount has not been incurred at the year-end and concerns the estimated legal costs for the company's defense of a claim for damages against it by an ex-employee. The employee was retrenched in January 2002. As the court case started in September 2002, this is an over provision (carried forward to the list of immaterial errors.

5. Provision for credit notes

   This provision is maintained at Sh 750,000 and is for possible credit notes after the year-end relating to invoices issued before the year-end. As the average monthly credit notes amount to approximately Sh 720,000 the provision is considered to be sufficient.

6. Provision for management bonuses

   All managers are entitled to a bonus based on criteria which are determined a year in advance at their annual performance review interview. Mr. chege refused to give me a list of bonus amounts or the letters setting out the bonus criteria, as the amounts have not been finalized and are still confidential.

The provision appears to be reasonable when expressed a as percentage of turnover - 0.45% (2002) compared to 0.47% (2001)

Your are required to:

(a) Define inherent risk and indicate in respect of the line item "sundry accruals and provisions" what effect the proposed turn over has on:

   1. Your assessment of the inherent risk (2 marks)
   2. Your audit approach (3 marks)

(b) Draft review notes to the senior in charge of the audit on any five of the seven items making up the balance of sundry accruals and provisions. In each case you should indicate
   (i) Whether you are satisfied with the basis of calculation and the accounting principles applied. (8 marks)
   (ii) What additional audit work, if any, needs to be performed? (7 marks)

(Total: 20 marks)

QUESTION THREE

You are auditing the financial statements of Twendelee Trading Co Ltd., a listed company, for the year ended 31 October 2002. The audit assignment partner has asked you to consider the auditors responsibilities for identifying subsequent events. Also, he has asked you to describe the audit procedures, which examine subsequent events. He has suggested that an example of one point in answer to part (b) below would be:

"Checking accounts receivable cash, received after the year-end to determine the realizability of accounts receivable balances at the year-end and highlight doubtful balances on the accounts receivable ledger".

The detailed audit work was completed on the morning of Friday 6 December 2002. It is proposed that:

1. The audit report is signed on Friday 20 December.
2. The financial statements are sent to shareholders on Monday 6 January 2003.
3. The company's annual general meeting will be held on Wednesday 29 January 2003. At this meeting the shareholders will vote to approve the financial statements.

Your are required to:

(a) Consider the auditor's responsibilities for detecting material subsequent events in the periods:

(i)	31 October to 6 December 2002.	(2 marks)
(ii)	6 December to 20 December 2002	(2 marks)
(iii)	20 December 2002 to 6 January 2003	(1 mark)
(iv)	6 January 2003 to 29 January 2003	(1 mark)
(v)	After 29 January 2003.	(1 mark)

(b) List and briefly explain audit procedures, which involve examination of subsequent events. (10 marks)

(c) Describe the work you will carry out in period (a) (ii) above (3 marks)

(Total 20 marks)

QUESTION FOUR

AZ Ltd is a large public construction company with annual sales of Sh 25 billion and its draft income statement shows a profit from operations for the year-ended 30 September 2002 of Sh 3 billion. This is the first audit by your audit firm. Inquiry of the previous auditors revealed no reasons for concern. On completing the audit work at the company's premises, the audit senior has drafted a memo extracts from which are reproduced below:

1. Inventory valuation

Inventories include Sh 525 million at cost of scrap rubber. This material is widely used as a road surface in other countries. Contracts for road building with this country's Ministry of Construction, the state authority for road construction does not currently permit the use of this material. However, the matter was known to be under review and on being offered a special purchase of this material. AZ Ltd speculated on a favorable outcome of the review and purchased the material. In November 2002, shortly before the financial statements were approved by the directors, the ministry of construction reported that it would not currently accept the use for this material. If used on non-ministry of construction contracts, the materials net realizable value would not exceed Sh 150 million. The chief financial officer maintains that as the Ministry of Construction's report was issued after the balance sheet date, the write down of the inventory should be reflected in the next period's financial statements.

2. Depreciation

In 1998, the company purchased two computer controlled earthmovers at a cost of Sh 188 million each and a further two at the same price in 1999. Depreciation has been provided at 10% per annum straight line, the same basis as it previously depreciated conventional earthmovers.

This year, 2002, the company decided that improvements in technology made it worthwhile scrapping the first two computer controlled earthmovers and replacing them with the latest model at a cost of Sh 300 million each. The company's chief engineer tells you that technology is developing so rapidly it appears likely they will continue to replace these machines every five years. The chief financial officer claims that the depreciation rate of 10% is in the line with industry standards and reflects the physical life of the machines. He argues that continued improvements in technology cannot be foreseen and that there is no justification for increasing deprecation to 20% per annum because of the possibility of technological obsolescence.

3. Contingent liability

The company is being sued for Sh 4 billion by the Ministry of Construction for defective work on a recently completed road. The company maintains that it met the ministry's construction's specifications and that it is the Ministry's engineers who are at fault in drawing up the specifications. AZ ltd maintains that it has no case to answer, that the possibility of loss is remote and that the claim need not be disclosed as a contingent liability.

An investigative journalist has recently published an article suggesting that other roads constructed by the company exhibit similar faults. The chief executive officer has admitted that the company's road building techniques are under investigation by the Ministry of construction. If the company were to lose the case, its future as a going concern would be threatened.

Required:

Explain the effect of each of the three matters, namely: inventory valuation, depreciation and contingent liability (i) on the financial statements and (ii) if the company were to refuse to amend the financial statements on the auditor's report. **(Total: 20 marks)**

QUESTION FIVE

(a) It has been argued, especially after the ENRON issue, that an auditor's independence may be compromised by the provision of other non-audit services such as shown below:

1. Calculating the company's income tax liability and the director's income tax liability and negotiating with the tax authorities.
2. Preparing the company's financial statements for audit from the accounting records.
3. Advising on systems of internal control.

Required:

For each of the services listed in (1) to (3) above, consider:

(i) The effect on the auditor's independence of providing these services. (3 marks)
(ii) The benefits provision of these services may provide to the client. (3 marks)
(iii) The procedures the audit firm should institute to minimize the risk of providing these services affecting their independence. (4 marks)

(b) Research has shown that the fees charged to listed companies by audit firms for non-audit work are on average about equal to the audit fee. It is alleged that:

1. Audit firms are charging low audit fees in order to obtain lucrative non-audit work.
2. With large fees from non-audit work, auditors will be reluctant to qualify their reports because of the risk of losing both the audit and the non-audit fees.
3. Auditor's reluctance to qualify their audit reports compromises their independence.

If these allegations are correct, then auditors of listed companies should be prevented from providing other services to client companies.

Required:

Discus this statement considering each of the matters raise above and come to a conclusion on whether external auditors should be allowed to provide other services to the listed companies they audit. (10 marks)

(Total: 20 marks)

KENYA NATIONAL AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATIONS

JUNE 2003

QUESTION ONE

You are the partner in charge of the audit of Futuristic Components Limited, a private company which intends to seek a public quotation for its shares.

The company is required to prepare a prospectus which must incorporate a report by the auditors of the company. The directors intend to include a profit in the prospects and you, as the company auditor, will therefore be required by the Stock Exchange to report on the base and calculations for the forecast.

Required:

(a) What are the preliminary considerations to be borne in mind before you would accept responsibility for reporting on the profit forecast? (6 marks)

(b) In your staff briefing as to the method of approach to be adopted in the profit forecast review, list six pertinent issues which staff should consider in their examination of procedures followed by the company in preparing the forecast. (12 marks)

(c) If you do not consider that certain assumptions in the forecast appear to be realistic, what action should you take? (2 marks)

(Total: 20 marks)

QUESTION TWO

You are the auditor senior for Kenya Computer Sales Ltd., a distributor of microcomputers, and have just completed the interim audit. When you and your staff were auditing the accounting records, systems and controls, you recorded in your files the following information:

1. The credit limits for four customers of Kenya Computer Sales Ltd. had been substantially exceeded and new customers in the last twelve months had not been allocated credit limits.
2. When testing a sample of fifteen purchase invoices, you noted that one purchase invoice had been posted twice to the purchases ledger by mistake and two other purchase invoices could not be traced.
3. The results of a stock take conducted at the half year revealed that some microcomputers supposed to be in stock were missing and that other microcomputers which had been returned by customers were in stock but had not been recorded as having been returned. A few of the missing microcomputers have been traced to directors and staff who have borrowed them for personal use at home.
4. Leasing agreement for microcomputers offered by Kenya Computers Sales Ltd. to its customers have been queried by the Kenya Revenue Authority (KRA) who are not satisfied that the terms of the agreement which give the customer the right to purchase the equipment at a future date, qualify them as leases as opposed to hire purchase agreements. These agreements have been in use for a number of years and were vetted by your firm.

Required:

(a) Draft a management letter addressed to the board of directors commenting on the weaknesses you have discovered, the risks arising from those weaknesses and your recommendations for improvements. (14 marks)
(b) Comment on any significant impact these matters may have on your year-end audit work. (6 marks)

(Total: 20 marks)

QUESTION THREE

Panafrican Electrical Ltd. manufactures a small range of standard electrical switches, sockets and plugs, and supplies them to electrical wholesalers throughout the country. Turnover for the year ended 31 October 2002 was approximately Sh.240 million. The products of the company have not changed for many years and turnover and profits have recently increased, broadly in line with the rate of inflation.

Your firm is the auditor of Panafrican Electrical Ltd. and you have attended the stock take and planned the audit for the year ending 31 October 2003, prior to the production of any management accounts for the year. On receipt of the draft management accounts for the year, your analytical review of the management accounts reveals that:

1. The gross profit percentage has increased from 32% to 36%
2. Stocks at the end of the year represented 35% of the purchases during the year as compared with 25% for the previous year.
3. Purchases of materials show a gradually increasing trend each month throughout the year except for the last month of the year which shows a decrease of 30% as compared with the previous month.

Required:

(a) Specify how the results of your analytical review will influence your final audit procedures, indicating the factors you would consider in drawing a conclusion from your analytical review. (12 marks)
(b) State the review procedures you would carry on the final draft of the financial statements before presentation to the directors for signature. (8 marks)

(Total: 20 marks)

QUESTION FOUR

Mal Engineers Ltd. are aircraft service engineers with a current annual turnover of approximately Sh.96,000,000. Generally, customers are invoiced for maintenance work at the time that service is provided although the company offers their customers a three-year service contract on payment of a non-refundable fixed fee at the beginning of the contract.
You have been appointed as the auditor, your predecessors having resigned after completing the audit for the year ended 30 September 2002. The previous auditors' report was unqualified. You have commenced the planning of the audit of the financial statements for the year ending 30 September 2003 and have found that, on the basis that payment for the three year service contract are non refundable, the directors have in previous years taken credit for all such income at the time that the contract is entered into. The management accounts for the year ended 30 September 2002 was Sh.5,760,000 and income from service contracts entered into during the year amounted to Sh.25,800,000.

Required:

(a) Your reservations, if any, on the accounting treatment of the income from the three-year service contracts.

(b) Your recommended treatment of such income together with the disclosures you consider necessary, in order for the financial statements to show a true and fair view.

(12 marks)

(Total: 20 marks)

QUESTION FIVE

The Chief Executive of Modern Supermarkets Ltd., a large supermarket chain, is concerned about the controls in the company's computerized purchases ledger by the purchases accounting department, and the computer automatically raises the cheque when the invoice is due for payment. The relevant information with regard to payment by cheque is as follows:

1. For payment under Sh.5,000 per printed cheques are used and no further authorization of the cheque is required, as the authorized signature is included in the preprinted cheque.
2. For payments above Sh.5,000 but below Sh.50,000 an authorized person is required to initial the cheque.
3. For payments over Sh.50,0000 an authorized signatory must sing the cheque.

Required:

Describe the controls which should be in operation to prevent fraud and error in the company's purchases system in relation to:

(a) Controls to ensure that only authorized purchase invoices and credit notes are posted to the purchase ledger.

(b) Controls over the addition, amendment and deletion of suppliers from the suppliers' list and ensuring that only authorized suppliers are on the standing data file.

(c) Controls over the cheque payments and the custody of the cheques.

(8 marks)

(Total: 20 marks)

KENYA NATIONAL AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATIONS

DECEMBER 2003

QUESTION ONE

You have been the auditor of Nairobi Super Furniture Ltd. for the last ten years. The company manufactures furniture for the local and export markets. The shares in Nairobi Super Furniture Ltd. whose year end is 31 December changed hands during the year, resulting in 74% of the shares now being owned by a company in Vienna (Austria).

The directors of Nairobi Super Furniture Ltd. have informed you that the audited financial statements must be delivered to the holding company in Vienna by 15 January 2004 for consolidation purposes. The year end of the holding company in Vienna is also 31 December. You are currently planning your audit.

Required:
State the actions to be taken to perform the assignment within the time restriction. Discuss this in terms of:
(a) Steps to be taken by the client (9 marks)
(b) Steps to be taken by the auditor (11 marks)
(Total: 20 marks)

QUESTION TWO

Your friend Cosmas Chege was recently appointed managing director of Triple M. Ltd. Cosmas is a marketing specialist and has frequently requested for your assistance in regard to financial matters. He is aware of the importance of sound internal controls and has asked you to advise him in regarding the internal controls at Triple M. Ltd.

He has provided you with the following details:

1. The company purchases and sells various consumer products which are stored at its warehouse in Athi River town.
2. The warehouse is surrounded by an electric fence with only one entrance which is permanently manned by a security guard.
3. All sales are on credit and are made by sales representatives who travel throughout the country.
4. Goods are delivered by the company's own fleet of vehicles.
5. The company employees the following staff
   - A sales director and his assistant
   - 14 sales representatives
   - A stores manager and 10 stores assistant
   - 7 drivers
   - A credit controller and her assistant
   - 2 invoicing clerks
   - A financial director and 3 accounting staff
   - An operations director and 3 buyers

- A security manager and 6 security personnel

6. All transactions are recorded on the following pre-printed, pre-numbered documents
   - Sales orders
   - Delivery notes
   - Credit notes
   - Sales invoices
   - Purchase orders
   - Goods received notes
7. Monthly management accounts incorporating comprehensive financial reports are presented by the financial director.

You have agreed to assist Cosmas and have decided to commence with the sales system. You have already explained:

(i) The necessity for proper segregation of duties, and

(ii) That the accounts receivable ledger and general ledger should be properly controlled, monthly statements should be sent out timeously, and proper financial reports including age analyses, relating to accounts receivable should be prepared regularly and circulated properly.

Required:

Describe a suitable system of interest control over credit sales. Do not deal with the aspects dealt with in (i) and (ii) above.

(Total: 20 marks)

QUESTION THREE

You are the new audit manager on the audit of Tex Ltd., a company which manufactures office and household furniture. The financial year end of the company is 30 June and you took charge of the audit on 20 August 2003 after the resignation of the previous audit manager.

The following are extracts from the audit planning memorandum:

1. Shareholding:
   Currently all shares are held by the directors. A takeover offer has been received from Malt Ltd. a listed company to buy 51% of equity shares of Tex ltd. Takeover negotiations are already under way.
2. Materiality
   The materiality level has been set at Sh.2,500,000. While reviewing the audit work papers for the year ended 30 June 2003, you find the following notes prepared by the senior in charge of the audit:

Sundry accruals and provisions

	2003 Sh.	2002 Sh.
Sundry accruals	6,290,010	8,382,530
Provision for leave allowances	3,002,850	10,302,710
Provision for major maintenance	13,257,410	20,000,000
	22,550,270	38,685,240

Notes:

(a) Sundry accruals
For a full list of accruals see working paper H2.1. Supporting documentation has been seen for all accrued amounts over Sh.100,000, totaling Sh.4,275,380 (68%). All accruals are for normal expenses of the company and appear to be reasonable.

(b) Provision for leave allowances
This amount agrees with the total leave allowances due on the print out from the salaries system. We have reviewed the controls in the salaries system, including the computerized leave records and have tested the controls through tests of controls. No weaknesses or exceptions have been found.
The reason for the lower provision is that the company has changed its leave policy. From 30 June 2002, only management may carry forward leave days due to them, from one year to the next. I have discussed and confirmed the new policy with Mr. Peter Nyaga, the financial director.

3. Provision for major maintenance
The only movement on this account during the year has been maintenance expenses of Sh.6,742,590 debited against the account. I have seen supporting documentation for expenses totaling Sh.1,415,900 (21%).

Required:
(a) Discuss for the line item 'sundry accruals and provisions' the effect of the proposed takeover on your audit approach (5 marks)

(b) Draft review notes to the senior in charge of the audit on each of the items making up the balance of 'sundry accruals and provisions'. In each case you should indicate:
(i) Whether you agree with the accounting treatment (5 marks)
(ii) Whether you are satisfied with the audit work performed and (5 marks)
(iii) What additional audit work, if any, needs to be performed (5 marks)
(Total: 20 marks)

QUESTION FOUR

The management of your client, Price Right Wholesalers ltd. are most perturbed due to information they have recently received that a conglomerate is considering a bid for the controlling interest in their company. The information indicated further that the sole intention behind the takeover is to dispose of the assets of Price Right Wholesalers Ltd. in order to realize a large capital profit.

Price Right Wholesalers ltd. has been listed on the Nairobi Stock Exchange for the last twenty years. In the recent years however, the company's earnings per share have been steadily declining which has resulted in the current market process of the share being well below the net asset value per share.

At the commencement of your final audit for the year ended 31 October 2003, you are handed price Right Wholesalers ltd. draft finical statements for the year which show a substantial increase in net profit over the previous year. You have ascertained that the company's method of operation, its level of efficiency, its sakes volume, the selling and purchase prices and the non-wholesaling revenues are relatively unchanged compared with the previous years.

Required:
(a) List the methods which could have been used to overstate the profits for the year ended 31 October 2003. (10 marks)
(b) Describe briefly, for each method in (a) above the audit procedure which would be used to verify whether or not that method has been used. (10 marks)
(Total: 20 marks)

QUESTION FIVE

Your staff have recently completed the fieldwork in respect of the audit of Craig Ltd. for the year ended 30 September 2003. You have been the company's auditors since inception.

The entire share capital has been held by Mr. G. Craig since incorporation. While working on the audit of your assistant discovered a file which appeared to indicate that substantial money in respect of cash sales had not been recorded in the accounting records and were also not included in turnover per the company's VAT returns.

Your assistant found this quite disturbing as, in addition to the audit, your firm assists Mr. Craig with the VAT returns and completes both the company's tax returns and Mr. Craig's personal returns.

Mr. Craig admitted to your assistant that he has for some years followed the practice of 'pocketing' most of the cash sales of the company. Mr. Craig was reluctant to discuss the matter in detail although he did not make it clear that he felt that Craig Ltd. was his company and that the auditors should not 'dig too deeply'. Besides the 'company makes a healthy profit and already pay too much tax'.

Required:

(a) Discuss the attitude you could adopt and the action, if any, you would take in the circumstances. (16 marks)

(b) Explain how your answer in (a) above would differ if your firm was doing the audit for the first time (2 marks)

(c) Explain your response if Mr. Craig were to ask for your immediate resignation (2 marks)

(Total: 20 marks)

KENYA NATIONAL AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATIONS

JUNE 2004

QUESTION ONE

You are the auditor of Tropical Garments Ltd., one if Kenya's largest garment manufacturing companies. Because of the size of the company's operations, labour costs represent the major portion of the company's production costs for the year.

The managing director, Mr. Lawson, has consulted you concerning the company's accounting systems and systems of internal control. He is particularly concerned with the payroll system as the company's accountant, whose services were terminated last month, he had neglected his duties generally, and in particular, had left the management of the payroll system totally to his junior staff.

The company employs approximately 300 workers in six (6) departments. Within the departments, there are a number of supervisors each of whom is responsible for 10 to 20 workers. A production manager and his assistant are responsible for the overall operations of the factory.

The payroll cost is currently approximately Sh.1,800,000 per week and Mr. Lawson suspects that there may be a number of irregularities such as payments to none existent employees and/or the payment of a full week's wages to employees who took time off.

Initially, Mr. Lawson wanted you to criticize the company's existing system, but he has now requested you to design a new system from scratch. Owing to a shortage of resources, the company is not able to:

- Increase its administrative staff. At present there are four administrative staff, the accountant, an accounts assistant and two clerks.
- Computerize the payroll system
- Outsource the preparation of the payroll (outsourcing is giving the work to an independent, third party such as computer bureau)
- Establish a separate Human Resources function. At present the production manager and his assistant perform this function. Mr. Lawson has already implemented the following controls:
  - The production manager of his assistant approves the employment of new staff in writing. A new employee form is used.
  - The company obtains proof of identification such as a copy of each worker's identity card.
  - The employees' normal hours of work are subject to an agreement between the company and a trade union.
  - Minimum rates of pay have been agreed with the trade union. The company generally pays rates in excess of the required minimum rate of pay as agreed with the union.
  - Mr. Lawson approves all rates of pay increases in writing.
  - The company issues workers with formal written contr4acts of employment, which are signed by Mr. Lawson.

- The above documents are then sent to one of the clerks and retained in a permanent employee file for each worker.
- Any termination of employment is advised to the clerk in wiring
- Mr. Lawson has also mentioned that:
- Owing to pressure from the trade union, the company is forced to pay the weekly wages in cash and cannot implement a system of payment by bank transfer
- Employees are expected to work overtime from time to time
- A mechanical time clock is located at each of the two entrances to the factory.

Required:

Draft a letter to Tropical Garments Ltd. in which you set out your recommendation for a suitable system of internal control over the payment of weekly wages. **(Total: 20 marks)**

QUESTION TWO

You are the audit supervisor on the audit of RS Ltd., a company listed on the Nairobi Stock Exchange. RS Ltd. sells building materials, plumbing supplies and ceramic tiles through its home improvements retail outlets.

The results of operations and the financial position of RS Ltd. for the previous financial year as well as the current financial year are summarized as follows:

	Actual Year ended 31 December 2003	**Budget Year ended 31 December 2003**
	Sh. Million	Sh. Million
Turnover	11,480	13,780
Profit before interest and tax	1,270	1,500
Profit before tax	920	1,200
Profit after tax	630	800
Ordinary shareholders' funds	3,240	3,640
Total assets	5,500	6,000

You are currently planning the audit for the year end 31 December 2004. The following matters have come to your attention during your review of last year's working papers and the most recent management accounts and during discussions with the financial director of RS Ltd.

1. MPH Ltd., the holding company of RS Ltd. is in financial difficult. MPH Ltd. holds 50% of the ordinary shares in issue.
2. RS Ltd. also has retail outlets in Tanzania, Uganda, Ethiopia and Sudan.
3. The managing director of RS Ltd., Mr. Peter Rush, has acquired an interest in a national car hire business. It appears from discussions with the financial director of RS Ltd. are encouraged to use this car hire company at all times. Car hire expenditure is a material component of the operating costs of RS Ltd.
4. The RS Ltd.'s pension fund has a large surplus. During the current financial year, the company has temporarily suspended its contributions to the pension fund.
5. RS Ltd. made a loan to Mr. Peter Rush to purchase shares in the company. The financial director intends to obtain repayment of the loan before the financial year end and to re-advance the funds from the RS Ltd. share trust.
6. RS Ltd. is currently involved in a dispute. A customer is alleging that certain building supplies purchased from the company were sub-standard and the customer is claiming damages of Sh.50 million. RS Ltd. has rejected this claim. A preliminary trial date has been set for February 2005.

During a discussion with Mr. Peter Rush he offered to supply, free of charge, the bathroom tiles and plumbing materials for the house you are in the process of building.

Required:

(a) Outline the potential audit risks apparent from the above matters and state briefly the audit procedures necessary to address the risks you have identified. Detailed audit programme steps are not required. You simply need to set out each of the issues that will need to be covered by your audit procedures. (16 marks)

(b) Indicate what matters you need to consider, what steps you should take before responding to the offer from Mr. Peter Rush. In addition, state what you believe to be the appropriate response to Mr. Peter Rush. (4 marks)

(Total: 20 marks)

QUESTION THREE

Your firm is responsible for auditing the financial statements of HK manufacturing Ltd., a privately owned incorporated business, for the year ended 31 May 2004. The company operates from a single site. Its sales are Sh.380 million and the profit before tax is Sh.8,360,000. There are no inventory records so the inventory counts at the year end will be used to value the inventory in the financial statements. As Monday 31 May 2004 is a normal working day, it has been decided that the inventory should take place on Sunday 30 May 2004 when there is no movement of inventory.

The company has produced the following schedule to determine the value of inventory at 31 May 2004 from that counted on 30 May 2004.

	Sh.	Sh.
Value of inventory – 30 May 2004		44,326,772
Add: Cost of goods received on 31 May 2004	833,644	
Production ;labour on 31 May 2004	247,760	
Overheads relating to labour at 120%	297,312	
		1,378,716
Less: Cost of goods sold on 31 May 2004		2,792,240
Value of inventory at 31 May 2004		42,913,248

The company keeps basic accounting records on a microcomputer using a standard software package. The accounting procedures for sales, purchases and wages comprise:

1. Dispatch notes are raised by the shipping department when the goods are sent to customers. Sales invoices are produced from dispatch notes. Sales invoices are input into the computer which posts them to the accounts receivable ledger and the general ledger.
2. When goods are received, a goods received note (GRN) is prepared, purchase invoices are matched with GRNs and purchase orders are authorized by the chief executive officer. After the purchase invoices have been authorized, they are input into the computer which posts them to the accounts payable ledger and the general ledger.
3. For the wages system, the hours worked by each employee are input into the computer which calculates the gross wage and deductions; PAYE, NSSF, NHIF and the net pay. All employees are paid weekly.

Required:

(a) The audit procedures you should perform to verify the accuracy of the inventory count:

(i) Before the inventory count, and (5 marks)

(ii) On the day of the inventory count (5 marks)

Your answers to parts (i) and (ii) above should include details of the matter you should record in your working papers for follow-up at the final audit.

(b) The substantive procedures you should perform to check the company's schedule as shown above which adjusts the value of inventory at 30 May 2004 so that at the company's year end of 31 may 2004.

You are required to verify the total value of inventory of Sh.42,913,248 at 31 May 2004. You are not required to describe the procedures necessary to verify the accuracy of the individual values of raw materials, work in progress and finished goods, as required on IAS 2 – inventories. (6 marks)

(c) The substantive procedures you should perform to check the purchases cut off at the year end. (4 marks)

(**Total: 20 marks)**

QUESTION FOUR

(a) The partner in charge of your audit firm has asked your advice on frauds which have been detected in recent audits.

The audited financial statements of a client, Lam Trading Ltd., were approved by shareholders at the Annual General Meeting on 3 June 2004. On 7 June 2004 the managing director of Lam Trading discovered a petty cash fraud by the cashier. Investigation of this fraud has revealed that it has been carried over a period of one year. It involved the cashier making out, signing and claiming petty cash expenses which were charged to motor vehicle expenses. No receipts were attached to the petty cash vouchers. The managing director signs all cheques for reimbursing the petty cash float. Lam Trading Ltd. has sales of about Sh.160 million and the profit before tax is about Sh.12 million. The accountant has prepared the draft financial statements for audit.

The partner in charge of the audit decided that no audit work should be carried out on petty cash. He considered petty cash expenditure was small, so the risks of a material error or fraud was small.

Required:

(i) Briefly state the auditor's responsibilities for detecting fraud and error in financial statements (3 marks)

(ii) Consider whether your firm is negligent if the fraud amounted to Sh.400,000 (3 marks)

(iii) Consider whether your firm is negligent if the fraud amounted to Sh.1,600,000 (3 marks)

(b) The audit of directors' remuneration at Wick Enterprises Ltd., a limited company has confirmed that the managing director's salary is Sh.18 million per annum and that he is the highest paid director. However, a junior member of the audit team asked you to look at some purchase invoices paid by the company. Your investigations have revealed that the managing director has had work amounting to Sh.8 million carried out in his home, which has been paid by Wick Enterprises Ltd. The managing director has authorized payment of these invoices and there is no record of authorization of this work in board minutes. The managing director has refused to include the Sh. 8 million in his remuneration for the year, and to charge the financial statements. If you insist on qualifying your audit report on this matter, the managing director says he will get a new firm to audit the current year's financial statements. The company's profit before tax for the year is Sh.640 million.

Assuming the managing director refuses to amend the financial statements, you are required to:

(i) Consider whether the undisclosed remuneration is a material item in the financial statements (3 marks)

(ii) Describe the matters you will consider and the action you will take:
- To avoid replaced auditor, and
- If you are replaced as auditor, assuming the managing director owns 60% of the issued shares of Wick Enterprises Ltd. (4 marks)

(iii) Describe the matters you will consider and the action you will take to avoid being replaced as auditor assuming Wick Enterprises Ltd. is a listed company with an audit committee, and the managing director owns less than 1% of the issued shares. (4 marks)

(Total: 20 marks)

QUESTION FIVE

(a) In many small businesses incorporated as limited companies, the system of internal control is dependent upon the close involvement of the directors who may or may not be major shareholders. Often, when reporting upon such business, the auditor has to qualify his report.

You are required to describe the circumstances in which an auditor can report without qualification on a small company.

(b) Wananchi Commercial Bank is a major debenture holder in Kool Ltd., a manufacturing company. The liquidity position of Kool Ltd. has been deteriorating in the last few years to the extent that it has failed to pay interest on the debentures for three years. You are an audit trainee with Kiongo and Associates, an auditing firm. Wananchi Commercial Bank has appointed one of the partners in your firm to be the receiver manager of Kool Ltd.

Required:

(i) Explain two circumstances under which the partner may incur personal liability for acting as the receiver manager of Kool Ltd. (4 marks)

(ii) What steps should the partner take to minimize his personal liability when acting as the receiver manager of Kool Ltd? (4 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATIONS BOARD

CPA PART III

AUDITING AND INVESTIGATION

DECEMBER 2004

Answer ALL questions. Marks allocated to each question are shown at the end of the question. 3 hours

QUESTION ONE

Mwebeni Manufacturing Ltd. which has several branches in Kenya is proposing to install a new computer system. The finance director has asked you to suggest the controls which should be exercised over access to the computer system from remote terminals. All accounting data will be input into the computer from terminals and data from the branches transmitted to the main computer through the national telephone system.

Required:

a) Describe the general controls which may be established to prevent unauthorized access to the computer system from the remote terminals. Your answer should consider the effectiveness and limitations of each type of control. (8 marks)

b) Describe the additional procedures which could be exercised to prevent unauthorized access to the computer system through the national telephone system. (6 marks)

c) Briefly describe the controls which should be implemented in the accounts payable and payroll systems over:

   i) Retrieval of information. (2 marks)

   ii) Input of transaction data. (2 marks)

   iii) Updating of standing data files. (2 marks)

(Total: 20 marks)

QUESTION TWO

You are the audit manager at Zainabu and Associates responsible for the audit of the books of account of Ziwani Spares Ltd. in the course of the audit of the financial statements for the year ended 30 June 2004, your preliminary evaluation of the internal controls indicated that reliance could be placed on the system. However, compliance tests carried out during the audit disclosed that the system was not operating effectively. This situation has necessitated various amendments and additions to your original audit plan.

Required:

Describe the changes to be effected:

a) During the interim audit. (13 marks)

b) After the end of the financial year. (7 marks)

(Total: 20 marks)

QUESTION THREE

The International Auditing Practices Committee requires that doubts about the going concern presumption be detected and adequately disclosed in the financial statements and auditors' reports.

Required:

a) Explain the term "going concern" in relation to the preparation of financial statement.

(4 marks)

b) Describe the audit procedures the auditor should undertake in order to obtain sufficient audit evidence to be able to form an opinion on the going concern status of the company. (6 marks)

c) List six factors which might cast doubt on the going concern status of a company. (6 marks)

d) Discuss briefly how the present responsibilities of the auditor regarding the going concern status of company could be extended. (4 marks)

(Total: 20 marks)

QUESTION FOUR

a) Corporate governance has become an issue of world wide importance. In furtherance to corporate governance, audit committees have been established by various companies.

Required:

Explain six ways in which the establishment of an audit committee would assist in improving the effectiveness of external audit work. (6 marks)

b) The ban on advertising of accountancy services in Kenya is not sustainable. Discuss. (10 marks)

c) The auditors have a legal duty to their clients. This legal duty appears to have, of late, been extended to cover third parties not in direct contractual relationship with the auditors.

State specific actions an auditor or an audit firm should take to minimise liability deriving from audit risk. (4 marks)

(Total: 20 marks)

QUESTION FIVE

In the past, the accountancy profession has been criticised for its role in monitoring and reporting potential corporate failure. Radical reforms have been called for in the way the accountancy profession is regulated. There have been calls for legislation in the following areas:

1. Auditing standards:
   Auditing standards should be set and enforced independent of the accounting profession.
2. Fraud:
   Auditing firms should have a duty to detect and report fraud.
3. Non-audit services:
   Auditors should not provide their clients with non-auditing services.
4. Duration of auditors appointment:
   The appointment of auditors should be for a maximum period of seven years.

Required:

a) Describe the current regulatory and professional requirements relating to each of the main issues listed above. (12 marks)

b) With reference to current regulations in the above areas, discuss the reasons why the accountancy profession has been criticised. (8 marks)

(Total: 20 marks)

CPA PART III

AUDITING AND INVESTIGATIONS

JUNE 2005

Time Allowed: 3 hours

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

You are the partner responsible for the audit of Motor Fit Ltd., a large private company which operates as a retailer and fitter of car tyres and exhaust pipes. The company operates from two locations. Each location is treated as a cost centre for management accounting purposes.

The Chief Accountant is responsible for the central accounts department comprising eight staff members and reports to the Managing Director.

The Managing Director, who is not an accountant, has complained about the level of audit fees in the past. You have established that the major influences on the cost of the audit were as follows:-

i) The client prepared management accounts consisting of a detailed income statement and a balance sheet for each cost centre, from which the auditors produced financial statements in compliance with the requirements of the Companies Act and international financial reporting standards (IFRSs)
ii) The final audit work had commenced before the client had adjusted the management accounts for a number of substantial creditors arising from the late invoices received from suppliers, so that the audit team had to verify subsequent amendments to the first draft of the management accounts.
iii) As a result of the delays in the preparation of final management accounts, an additional member of staff was added to the audit team towards the end of the audit in order to meet a deadline imposed by the client after the final work had commenced.
iv) As a result of past acquisitions of businesses, four of the locations are operated as separate subsidiaries.
v) The client's accounting systems are being computerized over a three year period which commenced in 2003 and additional audit time had arisen in the year ended 30 September 2004 as a result of the need to ascertain and document the new systems which had been introduced.
vi) In view of significant problem which had arisen in the audit for the year ended 30 September 2003, extensive substantive tests had been carried out on the stock control system for the year ended 30 September 2004 although those tests disclosed no serious problems.

Required:

Write a letter to the Managing Director suggesting steps which the company should take to reduce the time spent on audit work for the current year ending 30 September 2005.

(**Total: 20 marks)**

QUESTION TWO

Before accepting other assurance engagements for audit clients, an auditor should consider the impact of the proposed engagement on the integrity and independence of the audit.

Required:

(a) Define the term "assurance engagement" and explain its purpose (4 marks)

(b) Explain the engagement risk that faces a practitioner who accepts an assurance engagement. (4 marks)

(c) Describe the forms of audit assurance reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk. (6 marks)

(d) Describe the forms of audit assurance reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk (6 marks)

(e) Identify and explain the potential threats to the independence of a firm involved in assurance engagements. (6 marks)

(**Total: 20 marks**)

QUESTION THREE

(a) Systems Technologies Limited, a listed company, deals in computer accessories. The company reported a significant decline in profits, for the year ended 31 December 2004. This decline was attributed to increased competition due to the entry of new dealers into the market.

The directors of Systems Technologies Limited project an improved performance for the year ending 31 December 2005. The annual accounts for the year ended 31 December 2004, which were signed on 24 April 2005, included a profit forecast of Sh.260 million for the year ending 31 December 2005. This contrasts with realized profit of 80 million for the year ended 31 December 2004 Sh.190 million for the year ended 31 December 2003. In order to realize the forecast profits, the directors intend to increase turnover by 7 per cent and to reduce overheads by 7 per cent.

To give assurance to shareholders and other investors, the directors have requested Kilonzo and Associates, the auditors of the company, to report on the profit forecast.

Required:

i) Define the term "prospective financial information" and identify the main challenge which reporting on such information poses to auditors. (4 marks)

ii) Summarise the procedures that Kilonzo and Associates should carry out in order to be in a position to report on the profit forecast for the year ending 31 December 2005. (10 marks)

(b) The question of the auditor's responsibility for the detection and prevention of fraud is highly contentious. The past few years have seen an increase in both the incidence and scale of corporate fraud, while the question of third party liability has also not be conclusively settled by case law.

Required:

Explain the procedure you would follow as an auditor in a fraud investigation.

(6 marks)

(**Total: 20 marks**)

QUESTION FOUR

(a) With reference to International Standard on Auditing 550 (Related Parties), discuss the responsibility of an auditor with regard to related party transactions.

(b) You are a partner in ABC Associates, a firm of Certified Public Accountants (CPAs) specializing in the audit of group accounts. One of your clients, Excel Ltd., is the parent company of a number of subsidiary companies. Some of these subsidiary companies are audited by other audit firms.

Your firm is in the process of determining the extent to which the work of these subsidiary company auditors can be relied upon in the audit of the accounts of the parent company.

Required:

i) Explain the factors you would consider in deciding on the extent to which you could rely on the work of the auditor of a subsidiary company. Your answer should include a consideration of the size of the subsidiary. (6 marks)

ii) Analyse the matters you would consider in deciding whether you should qualify your audit report on the parent company's accounts given that the audit report on the accounts of a subsidiary company is qualified. (6 marks)

(**Total: 20 marks**)

QUESTION FIVE

You have recently been appointed auditor of UPS Hotels Ltd., a company which owns and runs a number of hotels. The company has an established internal audit department whose staff operate form the head office and visit the hotels.

Each hotel has a computer which records the bookings of rooms for overnight accommodation and produces the billing account for each guest.

Required:

(a) List and briefly describe the work you would expect to be carried out by the internal audit staff of UPS Hotels Ltd. (10 marks)

(b) Describe the factors you would consider and the work you would perform to enable you assess the extent to which you could rely on the work of the internal auditors. (6 marks)

(c) Assuming that you conclude that the work of the internal audit department's reliable, describe the effect this would have on your audit work. (4 marks)

(**Total: 20 marks**)

CPA PART III

AUDITING AND INVESTIGATIONS

DECEMBER 2005

Time Allowed: 3 hours

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

The firm for which you work, is the auditor of STEP Manufacturing Ltd,. and you have been asked by the senior in charge to describe how you can use computer assisted audit techniques to audit the company's computerized sales and sales ledger system. STEP Manufacturing Ltd. will allow you to use your data on test files to check the correct operation of the accounting computer programs and to use computer audit programs to interrogate the sales ledger file. You have already satisfied yourself that controls over access to the sales ledger system are effective. You have established the following details pertaining to the computerized sales system:

1. Details of goods to be dispatched a re input into the computer and after approval by the credit controller, dispatch notes are printed in the dispatch department who send the goods to the customers.
2. The computer department prepares the sales invoices using prices from the price file. It posts the invoices to the sales ledger and the sales and VAT to the nominal ledger. The invoices are then sent to the customers.
3. Cash received and discounts allowed are posted to the sales ledger by the accounts department
4. The system allows posting of credit notes, adjustments (to correct errors) and writing off bad debts
5. At monthly intervals, statements are sent to customers.
6. The computer may print out the following information ay any time:
   - Details of transactions on any account.
   - An age analysis of sales ledger accounts.
   - The total of the balances on the sales ledger.
   - Details of transactions posted during the month
   - An analysis of sales income for the month.
7. The information required when inputting dispatch note details is as follows:
   - Customer account number
   - Date of dispatch (if different from the current date)
   - Part number and quantity of each item dispatched.
   - Any special discounts allowed to a customer.

Required:

(a) Describe the test data you would enter into the computerized sales system to check the correct processing of dispatch notes and sales invoices. (8 marks)

(b) Explain how a computer audit program may assist you in

i) Carrying out a circularisation of accounts receivable including selecting the accounts to circularize. (5 marks)

ii) Verifying the year end receivables in the sales ledger. (7 marks)

Notes:

i) In part (a) you are <u>not</u> required to describe how you would check the correct processing of cash discounts, credit notes and adjustments to correct errors.

ii) You are <u>not</u> required to describe in detail how you would carry out a circularisation of accounts receivable. You are only required to consider the aspects of a circularisation required by part (b) of the questions.

(Total: 20 marks)

QUESTION TWO

There is a growing demand in both the public and private sectors for professional accountants to provide assurance on a variety of subject matters by expressing a conclusion regarding the quality or context of the subject matter.

Required:

(a) Identify the five key elements of an assurance engagement. (5 marks)
(b) Explain the engagement risks that face a professional accountant who accepts an assurance engagement. (4 marks)
(c) Explain why an absolute level of assurance may not be given and the circumstances in which a reasonable assurance can be given. (5 marks)
(d) Identify and explain the potential threats to the independence of an accounting firm involved in assurance engagements. (6 marks)

(**Total: 20 marks)**

QUESTION THREE

Keen Sankori and Company are the auditors of JS Foundation, a charity formed many years ago from a large gift by JS Mkarimu. The income from the charity is used to pay school fees for needy students. The original gift has been invested in fixed interest bonds and shares in listed (quoted) companies. The trustees manage the charity and a full-time administrator keeps the accounting and other records and also pays the school fees by cheque.

The draft summarized income statement for the year ended 30 June 2005 and an extract from the balance sheet together with the comparative audited figures for 2004 are given below:

Income statements for the year ended 30 June:

	2005	**2004**
	Sh.	**Sh.**
Income:		
Fixed interest investments	3,536,000	3,352,000
Shares in listed companies	9,912,000	9,880,000
	13,448,000	13,232,000
Expenditure:		
Payments for fees	11,304,000	11,544,000
Administration costs	1,728,000	1,640,000
Audit and accountancy	376,000	360,000
Sundry expenses	224,000	208,000
	13,632,000	13,752,000
Net deficit for the year	(184,000)	(520,000)

Balance sheet extracts as at 30 June		
	2005	**2004**
	Sh.	**Sh.**
Cost of investment		
Fixed interest investments	40,896,000	40,896,000
Shares in listed companies	115,648,000	101,016,000
	156,544,000	141,912,000

The following additional information has been provided:

1. During the year, some shares were sold at a profit of Sh.14,632,000 and the proceeds were re-invested in shares of other listed companies.
2. There were not purchases or sales of fixed interest investments in the year ended 30 June 2005. In the year ended 30 June 2004 some of the fixed interest investments were sold and others purchases using the proceeds from the sale.
3. The charity is managed by voluntary trustees who meet four times a year, and the administrator keeps the minutes of the meetings.
4. The trustees receive application for school fees, and approve them if they are suitable and there is sufficient income from the investments.
5. The auditors of the charity prepare the financial statements from the accounting records kept by the administrator and audit those financial statements. Their audit report is addressed to the trustees of the charity.

Required:

Describe the audit work the auditors should carry out in order to:

(a) Verify that school fees are paid to authorised schools. You should consider how the auditors would verify the existence of the students. (6 marks)

(b) Verify income from investments. The audit tests should verify that all the income from the investments has been received by the charity and included in the financial statements, including dividends from the shares in listed companies bought and sold during the year ended 30 June 2005. (10 marks)

(c) Verify the ownership of the fixed interest investments and the shares in listed companies. (4 marks)

(Total: 20 marks)

QUESITON FOUR

You are the manager responsible for the audit of BCD Stores Ltd. which has a number of stores which sell household products to the general public, including furniture, electrical equipment, cooking equipment and carpets. The company has annual sales of about Sh.1,600 million. In previous years' audits, there have been problems with:

1. Misappropriations of inventory by employees and customers.
2. Slow moving and damaged goods which are worth less than cost, and
3. Incomplete recording of sales when the customers pay by cash (these represent 55% of all sales)

The company has a small internal audit department, the staff of which visit branches and perform appropriate audit work at the head office.

Required:

(a) Describe the work you will carry out and the matters you will consider in planning the audit prior to the commencement of the detailed audit work, including consideration of the timetable for the audit. (12 marks)

(b) Describe the procedure you will carry out to control the audit including reviewing the work of the audit staff. (8 marks)

(**Total: 20 marks**)

QUESTION FIVE

(a) State the respective responsibilities of the directors and management of a company and its external auditors with respect to the financial statements. (6 marks)

(b) Describe the inherent limitations facing auditors in undertaking their work. (6 marks)
(**Hint: Don not confuse inherent limitations with inherent risk**)

(c) Describe the significant types of judgements made by auditors in:
   i) Gathering evidence (4 marks)
   ii) Arriving at an opinion on the financial statements. (4 marks)

(**Total: 20 marks)**

ANSWERS – PAST PAPERS

JUNE 2000

QUESTION ONE

Tutorial Note:
This question was set when the International Accounting Standards (now called the International Financial Reporting Standards (IFRSs) were being introduced or adopted in Kenya.

The changes that were necessitated by the introduction of IFRSs in Kenya can be compared to the preparations that took place in the European Union (EU) toward the adoption of IFRSs in January 2005.

The early adopters of IFRSs faced significant problems such that the International Accounting Standard Board (IASB) released a new standard IFRS 1 – First time adoption of International Financial Reporting Standards.

IFRS 1 replaced SIC-8. First Time Adoption of IAS as the primary basis of accounting.

IFRS 1 applies when an entity adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs. In general, IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In particular, the IFRS requires an entity to do the following in an opening balance sheet that it prepares as a starting point for its accounting under IFRS.

i) Recognise all assets and liabilities whose recognition is required by IFRSs.
ii) Not recognize items as assets or liabilities if IFRSs do not permit such recognition
iii) Reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs and
iv) Apply IFRSs in measuring all recognized assets and liabilities.

IFRSs grants limited exemptions from these requirements in specific areas.

IFRSs became effective for first IFRSs Financial Statements on or after 1st January 2004.

The International Auditing and Assurance Standards Board (IAASB) has also pronounced guidance in this area and the student is advised to refer to the relevant guidelines.

In general, the changes that were necessitated by the adoption of IFRSs included:

i) The role of the technical committee of the Institute of Certified Public Accountants (ICPAK) changed from standard setting to interpretation and enforcement of compliance
ii) The applicable financial reporting framework in Kenya changed from the Kenya Accounting Standards (KAS) to International Financial Reporting Standards (IFRSs)

iii) For audits and related assurance services, the authoritative framework changed from th Kenya Auditing Standards (KAS) and Kenya Auditing Guidelines (KAG) to International Standards on Auditing (ISAs) and other pronouncements by IAASB.

iv) ICPAK has the role of interpreting Global Standards for the local environment and to reconcile IFRSs requirements with local requirements e.g. the Companies Act reporting requirements.

The benefits of adopting IFRSs especially for the multinational companies include:

i) Facilitates raising of foreign finance by obtaining several stock market listings
ii) To reduce analytical costs incurred in adjusting financial statements for differences in accounting practice
iii) To improve the corporate image by publishing better quality financial information in some cases.
iv) To enhance financial transparency and reduce the practice of financial principle shopping
v) To enhance the internal management of the company (MTCs) by use of a common accounting language in the management of their operations reducing irrational decision making
vi) To improve the comparability of financial information across borders. The rigid application and enforcement of IFRSs may be a problem
vii) Provides a reliable basis for corporate analysis.

Anticipated problems include;

i) Some companies may lack the expertise to apply IFRSs in full.
ii) There will be a significant cost in financial management information systems and training co-operate personnel in the use of IFRSs.
iii) IFRSs do not lay down comprehensive guidelines for corporate governance or any legal framework. This may result in conflict with local legal requirements hence necessitate modification of the standard
iv) IFRSs do not deal with specialized industries and thus local rules may apply which dilute the standards. Similarly national tax authorities may not accept IFRSs for taxation purposes.

In conclusion, companies will need to review their accounting policies, evaluate their procedure for the change without underestimating the work involved.

The student is reminded that the authoritative documents are IFRS 1 and IAS 8.

ANSWER TWO

AUDIT RISK ASSESSMENT

At the basic level we initially consider the competence and integrity of the management and staff and the business risks that the entity is exposed to and the circumstances brought about by the pressures on the entity that could induce management to distort the financial information.

This assessment would clearly indicate the potential errors and irregularities that could occur. This is then narrowed down to the particular account areas most susceptible to misstatements resulting from errors and irregularities.

Then through the use of checklist questionnaires and flow charts we consider the control structure of the company with regard to the accounting system, the control environment and the control procedures. We consider whether in design it would be effective in preventing, detecting and correcting on a timely basis errors and irregularities. Where we are satisfied the system is well designed we then carry out tests to confirm that in operation, the system is effective.

If the conclusion is that the system has been effective in its operation then we consider the figures presented in the previous financial statements and the latest management accounts. We apply analytical procedures to these figures and consider whether in the light of our expectations they make sense, that is they do not appear to be materially misstated.

The resultant figures that do not appear to make sense are then subjected to selective substantive procedures of details, that is vouched in detail and subjected to reviews to ensure they are adequately dealt with. Overall we seek to ensure that we attain a confidence level of 95%, thus we restrict our overall audit risk to 5%.

MATERIALITY CONSIDERATIONS

To ensure that we focus on important matters and not trivial or petty issues we assess materiality quantitatively and qualitatively from the initial planning to the final stage to the final review stage.

Quantitatively we use the following broad guidelines

For the Profit and Loss Account Items a matter would be materially if it is more than

1% of Turnover or
1% of Gross profit or
5% of Profit Before Tax (our common basis)

and for the balance sheet purposes, more than

1% of Total Assets or Equity or
5% of the relevant Balance Sheet Heading

Of course the cumulative effect of all errors and irregularities discovered is also considered in the assessment of materiality.

At the qualitative (nature) level we take into account the following matters

(i) The requirements of the Companies Act, International Accounting Standards and other regulations governing the industry
(ii) The effect on the reported results, such as turning a loss into a profit and vice versa
(iii) The effect on the trend of reported results
(iv) The effect of any adverse publicity

Normally, at the decision level,

(i) If the matter is less than 5% of Profit before Tax we only recommend in the financial records during the normal book keeping. The financial statements go without any qualification.
(ii) If between 5 and 10% of Profit before Tax then we consider the qualitative aspects to fully conclude on materiality
(iii) If more than 10%, we would insist on adjustment to prevent our issuing a qualified report.

SAMPLING

Due to the fact that we cannot test everything it is inevitable that we sample items for audit tests.

We apply statistical sampling techniques basically on the tests of controls, transactions testing and where large populations of transactions and balances are involved and out tests of control

have indicated that they are subjected to the same uniform procedures. Random numbers or items selected by the computer are used. Similarly the optimum sample sizes are based on Statistical Sampling Theory.

On verification of the balance sheet items the approach is biased towards high value and high risk areas. Thus the statistical sampling adopted includes consideration of stratified sampling.

We only draw conclusions on samples scientifically selected so that we can support our decisions scientifically.

Those transactions or balances that are unusual, one-off or with related parties, judgmental sampling is used and tests can be up to 100% to give maximum assurance.

ANALYTICAL REVIEW

We build up a history of the company based on a five year moving ratio and trend analysis that is updated annually and necessary changes made to the figures where those are changes in accounting policies.

We also make use of the trend analysis, investigations and budget comparisons and explanations produced as a normal consequence in the organizations normal activities and reporting of management accounts.

Based on this study we are able to apply analytical procedures and predict the finical statement balances. These are then compared with the actual achieved balances. When the evidence suggests that the figure is not materially misstated a much reduced amount of substantive procedures of details is performed. However, if the indication is that the figures are materially misstated then the substantive procedures are increased to cover for the detection risk.

We apply the procedures at the planning stage to identify audit risk areas and new developments.

During the audit we use analytical procedures to confirm completeness, accuracy and validity of information.

And at the final review stage to confirm consistency and completeness and to support the conclusions arrived at using other procedures, and to assess the overall reasonableness of the financial statements.

ANSWER THREE

1) Under the accruals assumption a prepayment is a payment made in one period but the benefit to be derived is properly for a future period. There must be a rational basis for determining the period over
which the future benefit will be derived.

   For the cost incurred of 15,840,000 to qualify as a prepayment consideration will have to be given to:

(i) The normal accounting policy adopted by the company. Whether the treatment being adopted is consistent with previous years

(ii) Whether the brochures and advertising is to be utilized after 30 April even though paid for in advance, such as whether there are still TV shows to be aired.

(iii) The ability to measure with sufficient reliability when the expenditure will be fully utilized.

(iv) How close to the year end it was incurred and whether the benefits can be spread into the future.

The figures prepaid represents 31% of the Profit before Tax. To defer it would appear to be distort the profit figure. It is unlikely that it is justified to treat it as a prepayment. The most likely effect n the auditors' report would be a qualification on disagreement although an emphasis of matter could suffice.

2) The analytical procedures indicate that the closing stock at 30 April 2000 was overstated However, the impact on the profit before tax of the possible misstatement is likely to be less than 1%.

If however the quantities can be determined based on sales and receipts of new supplies during the month of April 2000 then physical quantities can be determined and properly valued.

The materiality of the misstatement indicates a very small figure that would have no impact on the profit before tax.

Thus the impact on the auditors report is likely to be minimal and will not be mentioned. However, the auditors will refer to the matter in the management letter to the management.

The failure to take stocks is a major weakness in controls and should be rectified. A reference in the management letter will be sufficient.

3) Significant amounts of expenditure must be adequately supported to prove that they are complete, valid and accurately recognized.

The evidence to support the casual labour absolutely inadequate. The list required by the managers are not adequate evidence of the expenditure. This represents a major limitation of scope and appropriate audit procedures with regard to the report should be undertaken.

4) The correct procedure for the treatment of provisions is authoritatively prescribed in IAS 37. The provision of future maintenance of shs.24,000,000 is not in accordance with IAS . the amount involved is material and should therefore be adjusted , failure to which the report should be qualified.

ANSWER FOUR

Controls in a Computerised Information System can be classified as follows:

1. General Controls
   - Organisation and management controls
   - Application systems and maintenance controls
   - Computer operations controls
   - Systems software controls
   - Data entry and program controls

2. Application controls
   The purpose of application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded and are processed completely, accurately and on a timely basis.

   Application controls can be classified into:-
   (i) Controls over input
   (ii) Controls over processing and computer data files
   (iii) Controls over output

The questions deals specifically with input and processing controls and therefore the student should concentrate on these. (The question instructs the student in note form, therefore lengthy descriptions will not earn marks.)

Input controls will include input origination controls and input authorization controls.

a) Input origination control
- Edit checks
- Validations
- Access controls

b) Input authorization controls
- Online access controls
- Unique passwords
- Terminal identification limiting access to specific terminals
- Online source documents

c) Batch controls and balancing

i) Types of batch controls include:
- Total monetary accounts
- Total items
- Total documents
- Hash totals

ii) Types of batch balancing
- batch registers.
- Control accounts
- Computer agreements

d) Input error reporting and handling input controls include
- Transaction log
- Reconciliation of data
- Documentation of user, data entry and control procedures
- Error correction procedures
  - ✓ Logging errors
  - ✓ Timely corrections
  - ✓ Approval of corrections
  - ✓ Suspense file
  - ✓ Error file

Validity of correction
- Anticipation
- Transmitted log
- Cancellation of source documents

In online or database systems control over input is also critical. Batches can be programmed to be controlled by time of day, specific terminals or individual input of data.

Processing errors include editing and validation controls. Validation controls include:
- sequence check
- Limit check
- Range check
- Validity check
- Reasonableness check

- Table looking's
- Existence check
- Key verification
- Check digit
- Completeness check
- Duplicate check
- Logical relationship check

Processing controls include:-

- Edit check program
- Run to run totals
- Programmed version checks
- Reasonableness checks
- Limit checks on calculated amounts
- Reconciliation of file totals
- Exception reports

Data file and control procedures ensure that only authorized processing occurs to stored data and types of these controls include:

- Before and after image reporting
- Maintenance error reporting and handling
- Source documentation retention
- Internal and external labelling
- Version usage
- Data file security
- One for one checking
- Pre-recorded input
- Transaction logs
- File updating and maintenance organisation
- Parity checking

QUESTION FIVE

The engagement described has aspects of an investigation as well as a review engagement. Matters that require particular attention include procedural as well as subject matter issues.

This being an investigation and review of valuation of shares the procedure will be as follows:

1. Receive instructions from the clients and confirm the specific terms of reference
2. Communicate with other auditors as a matter of professional courtesy if the investigating accountant is not the auditor of the entity.
3. Discuss with the client and make logistical arrangements for the investigation
4. Obtain background information on the investigation including understanding the entity including its internal control and assess the risk of material misstatement in the financial statements.
5. Gathering of preliminary information with regard to the business and the valuation of shares
6. Prepare the report outline and discuss with the client so that the terms of reference and client expectations are confirmed
7. Carry out the investigation and review in detail according to the clients instructions and other professional or statutory requirements
8. Prepare my draft report and discuss it with the client
9. Finalise the report and deliver it to the client
10. Be available for further discussions, inquiries or other investigations.

Taking the above procedures ensures that the clients and the investigating accountant understand their specific roles and expectations and thus minimizes disagreements, and protects the auditor from litigation.

With regard to the financial statements and the valuation of shares, matters to pay particular attention to include:

- After observing the above procedures, normal courtesies, obtain copies of the audited accounts of the previous years (say three years) and critically analyse them
- Whether the accounting policies adopted are suitable and have been consistently applied over the years
- Perform analytical review of the figures and whether the figures and rations make sense
- Whether there were any qualifications in the auditors reports for the previous years and the nature of the qualifications

The audited accounts for the current period will be reviewed including:-

- Tests of controls over the controls relevant for the preparation of reliable financial statements
- Search specifically for any evidence of creative accounting such as fictitious sales, over valuation of assets, understatement of liabilities, big bath provisioning, impairment of assets and vice versa.

After the above, I would then pay particular attention to the basis of the valuation of shares.

In general, the value of equity shares are determined by the expected performance of the business and current financial performance, position, cashflows and the perceived economic environment.

In particular, attention will be focused on:-
The relevance and reliability of forecast performance and economic benefits inflow. The benefits expected to be derived from continuing to hold the shares such as expected dividends, capital gains and control of the resources of the company. Historical figures are important as a basis for forecasts.

Evaluate the methods of share valuation and ensure the accuracy of the computations.

There are two main bases;

1. Earnings basis
2. Assets basis

The earnings basis has two approaches;

1. Dividend yield method
2. Earnings yield method

The assets basis has two approaches also

1. Going concern basis
2. Break up value basis

Since the company is a going concern and the shareholding to be disposed off is significant, the methods of dividend yield and break up value is not relevant.

In my procedures, I will ensure that they have not been used.

I would review the computations obtained using any of the other two methods and ensure that the value is reasonable, taking into consideration the nature of the business.

JULY 2000

QUESTION ONE

1. The collapse of many large companies without warning
   To address this concern, the accounting profession should increase the disclosure requirements for companies. As such, companies should be required to disclose more information than is currently required such as more information on the operations of the company.
   In addition, the accounting profession should periodically review the viability of companies especially listed companies and those found in financial distress should be recommended to the Capital Markets Authority for delisting
2. The accounting profession should educate organizations on the importance of preparing their accounts to reflect a true and a fair view. Thus, if adhering to a particular accounting standard distorts, the true and fair view given by the financial statements, then such statements should deviate from such a standard. Disclosure should be made for the reasons of deviation.
   Thus, even though debtors meet the criteria to be good debtors as per the accounting standards and yet they are not, they should not be disclosed as such. The accounting profession should take stern steps against organizations who exploit loop holes in the accounting standards so as to mislead the users of the financial statements.
3. Lack of accountability due to companies being run by dominant characters.
   These can be addressed by organizations having an audit committee which would be made up of non-executive directors of the company. The board of directors would then be answerable to the audit committee. This would ensure some level of accountability by the directors to the audit committee.

4. Raids on company pension schemes by companies in financial difficulties.
   This has been a fairly common practice by companies in Kenya until the recent past. However, due to the social implications of this practice, the government stepped in and instituted the Retirement Benefit Act which in turn created the Retired Benefit Authority. This authority is responsible for ensuring that pension schemes are run independently of the company and that the funds are not available to the managers of the company. Any organization that contradicts the provisions of the retirement benefit authority are punished heavily.
5. Director's pay should ideally be determined by the shareholders at the annual general meeting. It appears that the majority of the shareholders in Kenya do not know this and they keep on delegating this task to the directors themselves.
   The accounting profession should educate the shareholders in their role in fixing the directors remuneration. In addition, organizations should set up audit committees, which among other things will vet the director's pay.
6. Insider trading refers to the use of insider information either for the benefit of oneself or a third party. To deal with this problem, the auditing profession should have stern penalties for its members who are found to be guilty of this vice. Organizations should also restrict ownership of shares by people who have access to insider information. Such parties as directors, employees and auditors should not own shares in their respective organizations.
7. The feeling that auditors are too close to the clients is brought about by the fact that audit clients rarely change auditors thus, as a result of auditing the same client for many years, it is felt that relationships inevitably develop, which will influence the effectiveness of the audit.
   The accounting profession can be able to alleviate this problem by ensuring that clients change their auditors periodically. It should set a ceiling for a number of years that, an audit firm can audit a client continuously at say five years.

8. Looseness of accounting standards comes about as a result of the many loopholes in accounting standards. As a result, one accounting standard can be interpreted in several ways. Indeed, it has been observed that when one loophole is sealed, other loopholes stem up to replace it.
   To address this problem, the accounting profession should strive to develop broad guidelines to guide accountants rather than developing detailed rules to address specific issues.
9. Opinion shopping is a fairly common practice in Kenya where companies (especially the directors) seek to have an auditor who will agree with them even if it means that the auditor has to compromise his objectivity.
   Opinion shopping should not be confused with obtaining a second opinion on an auditors report by a different auditor other than the one who carried out the audit.
   In order to address this situation, the accounting profession has given the auditor the right to make a representation at the general meeting at which it is proposed to replace him. As only the shareholders can remove an auditor from office, it is expected that the auditor will be able to inform them on the reason that the directors want him removed (which is that they do not agree with his report on the financial statement).

However, in Kenya, even though this right exists it usually does not seem to serve its purpose because:
Shareholders do not exercise their right to remove and appoint an auditor. They usually delegate this duty to the directors. Thus, effectively, the directors can be able to appoint and remove an auditor who does not agree with them very easily.

Therefore in order to address this situation:

1. Organizations should educate their shareholders on their rights especially in relation to auditor's appointment and removal.
2. The auditor who is incoming should communicate with the outgoing auditor to establish pertinent issues which relate to his appointment. If he establishes that, the company is out on an opinion-shopping mission, he should decline the appointment.

QUESTION TWO

(a) The original purpose of an audit trail was to preserve details of all stages of processing on paper. This meant that transactions could be followed stage by stage through a system to ensure that they had been processed correctly. Thus, a sales system record could be traced right through the system because the audit trail would show a reference to the customer order, delivery note, invoice and cheque receipt.

In a computerized system, visible evidence (such as the documents shown above are usually missing. However, the computer still has a transaction trail that may be invisible but which the auditor can access. This is possible because the computer can keep a log of all operations carried out on a particular transaction.

Errors embedded arise from a basic weakness in the system, and therefore they may recur frequently. In a stock control system, such an error may be the failure to restrict access to authorized personnel (by means to passwords) thus enabling the data to be tampered with.

(b) Segregation of Functions

In a centralized system, the principal segregation is between the user department and the computer department. The key principle behind it being that those who process the data should have no responsibilities for imitating or altering the data. The following segregation of responsibilities are particularly important.

1. The computer department manager should report to an executive who is not regularly involved in authorizing transactions for computer processing.
2. Computer personnel should not correct errors in input documents.
3. Computer personnel should not initiate or authorize transactions or have custody of the resulting assets within the computer department itself. There should be segregation to function along the following line:

JOB TITLE	RESPONSIBILITIES
1. Computer department manager	exercises overall control over the running of the department
2. Systems analyst	monitoring existing systems, designing new systems and preparing specifications for programmers
3. Programmer	develops, debugs and document programmers
4. Computer operator	keys input data into the computer
5. Librarian	maintains custody of systems documentation and off line programs and files
6. The data control group	liaises with user departments and monitors and controls input and output
7. Data base administrator	designs the content and organization of the database and controls access to and use of the database.

(c) The two most common types of CAAT are:
   (i) Audit software – programs used to examine the enterprises computer files
   (j) Test data – data submitted by the auditor for processing by the enterprises computer based accounting system.

(d) Application controls relate to the transactions and standing data of each application: they ensure the completeness and accuracy of the accounting records. An audit test appropriate to an application control would be the use of test data with documents missing to ensure a sequence check control was operating correctly.

General controls relate to the environment within which computer-based accounting systems are developed, maintained and operated. An appropriate audit test would be to check that all program changes were authorized.

QUESTION THREE

(a) Risk based auditing refers to the development of auditing techniques which are responsive to risk factors in an audit which can be analyzed as follows:

i. The risk that material error will occur (inherent risk;
ii. The risk that the clients system will not prevent or detect such error (control risk)
iii. The risk that undetected material errors will be overlooked by the auditors (detection risk).

The auditor applies judgment to determine what level of risk pertains to different areas of a clients system and devises appropriate audit tests. This approach should ensure that the greatest audit effort is directed at the riskiest errors, so that the chance of detecting errors is improved and time is not spent on unnecessary testing of 'safe' areas.

(b)

1. Audit risk is the risk that the auditor will come to an inappropriate audit opinion on financial statements. That is, the auditor will provide an unqualified report when there are material errors in the financial statements or will give a qualified report when there are no material errors.
2. Inherent risk is the risk of material errors in the financial statements before taking into account the effectiveness of internal controls. In most organizations the inherent risk is 100% or close to 100%. It is related to the type of business of the company. Companies with high inherent risk include those where a large number of the transactions are in cash (e.g. retailers), those where there is rapid technical change (e.g. where they may be taken over by the government, or there are severe exchange and other controls), companies with going concern problems and companies with a dominant chief executive.
3. Control risk is the risk that controls in the company's accounting systems will fail to prevent or detect material errors or fraud. In small businesses the control risk is likely to be high, as there will be too few staff to have an effective division of duties for internal control purposes, so in these businesses it is not appropriate to carry out compliance tests. Where there is an effective system of internal control, which is confirmed by audit tests, then the control risk will be low and this allows fewer substantive tests to be performed.
4. Detection risk is the risk that audit test (i.e. substantive tests and analytical review) fail to detect material errors. Detection risk is reduced by performing substantive checks on a larger sample of items.

In the definitions above, the work 'errors' includes irregularities, fraud and uncertainties.

(c) To assess inherent risk, the auditor uses professional judgment to evaluate numerous factors, examples of which are:

At the financial statement level

- The integrity of management

- Management experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- The nature of the entity's business, for example the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the umber of locations and geographical spread of its production facilities.
- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as identified by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.
- Financial statement accounts likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- The complexity of underlying transactions and other events, which might require using the work of an expert.
- The degree of judgment involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and moveable such as cash.
- The completion of unusual and complex transactions, particularly at or near period end.

Transactions not subjected to ordinary processing.

(d) The advantages of using the risk-based approach are that it provides a framework for the conduct of the audit. It focuses auditor's attention on risk. It allows development of efficient and effective audit programs and it develops an enquiring attitude of mind. In addition, the risk based approach links into the concept of materiality and the techniques of statistical sampling.

The audit risk approach is helpful in identifying the areas of the audit where most work should be performed. It allows the auditor to spend more time in the areas of highest risk and less time in low risk areas, thus either reducing the overall time for the audit or reducing overall audit risk. It avoids excessive time being spent on low risk areas. For instance, in many businesses petty cash expenditure is small. Although the risk of errors and fraud in petty cash systems are relatively high, it is most unlikely that they will be material (as total petty cash expenditure will hardly be material), so audit work in this area can be limited.

Where internal controls are weak, the control risk will be high, which will require a lower detection risk in order to achieve the required level of audit risk. This means the more substantive checks will have to be performed in that area.

Using the risk-based approach to auditing, the auditor will be able to examine each area of the profit and loss account and balance sheet and assess the inherent and control risks for these areas. The control risk will be confirmed by compliance tests. From this, a required level of detection will be determined as:

DR = AR/ (IR X CR)

A low detection risk will require a large number of items to be checked and a high detection risk will allow the auditor to check a small sample of items.

Essentially, by examining each significant item in the profit and loss account and balance sheet (i.e. in terms of materiality and inherent and control risks), the auditor will be able to assess the amount of work required in that area. For instance, with a capital-intensive

company the depreciation charge will be large, so checking its accuracy will be important. Where there are rapid changes in technology and risk of obsolescence, this will increase the inherent risk and require more detailed audit work. In many businesses the value of stock is material, and it has a high inherent and control risk, as there may have been counting errors, and there is a high risk of errors in the valuation of each item of stock, thus giving a high risk that the value of stock is materially misstated. Where there is a perpetual inventory system, stock quantities should be more accurate, (as counts can be compared with the stock records), which reduces the control risk. Thus, the risk of errors in stock quantities is reduced, so a higher detection risk can be permitted, which allows the auditor to carry out fewer checks.

With cash sales businesses, there is a high risk of misappropriation of cash, thus creating a high inherent risk. So, to ensure a low audit risk, it is necessary for the control risk to be determined by the auditor by checking that the systems for controlling and recording cash are reliable. If control risk is high, the auditor will have to perform extensive substantive checks.

As explained above, in very small audits, it is hardly appropriate to calculate audit risk, because of the time taken to assess each element of risk. However, it is worthwhile to consider audit risk from a qualitative point of view, as it is likely to highlight areas of highest audit risk and thus indicate where the auditor should concentrate his audit work.

(e)

There are a number of problems with the audit risk model. Frequently, it is impossible to estimate the values of inherent risk, and to a lesser extent, control risk with any degree of certainty. If these elements cannot be determined accurately, then one cannot accurately determine the value of detection risk which is required to achieve the overall level of audit risk.

A further problem is the auditors consider audit risk for each system – sales, purchases, stock, fixed assets, nominal ledger, cash, wages, etc. The auditor may decide an overall audit risk of 5% is acceptable. However, if an AR = 5% is used for each of the systems above, then the overall audit risk will be much higher than 5% (i.e. allowing 5% risk to sales/debtors, 5% to purchases/creditors, 5% to fixed assets/depreciation would give an overall audit risk of substantially more than 5%). So, there is a need to allocate audit risk between each system in a flexible manner, so that a higher level of audit risk is permitted in higher risk areas and a lower level of audit risk is allocated to low risk areas. So, for many systems, the acceptable level of audit risk could be as low as 1%.

Finally, there is the question of whether the audit risk equation given in the question its correct. Analytical review is used in many audits, and analytical review risk (ARR) should be included in the equation:

AR = IR X CR ARR X DR

As ARR will be less than 1, this will allow a higher value of detection risk (DR) and thus allow fewer audit checks to be performed so as to achieve the required level of audit risk. Once again, assessing ARR is likely to be subject to considerable error, as it is quite possible for analytical review to indicate no problems when there are material errors, uncertainties or fraud. Also, analytical review may indicate problems, where there are no material errors in the financial statements (e.g. an increase in debtors age indicates that there may be more bad debts, but these have been adjusted for in the financial statements).

A further problem is that the auditor may assume that his assessment of control risk may apply to the whole system (e.g. sales system). However, there may be little or no controls over some parts of accounting systems, so the control risk for these aspects of the system could be 100%. This could apply in the following circumstances:

- Adjustments made to the financial statements by the accountant for accruals and prepayments, and correction of other errors
- In the valuation of the year-end stock and determining the doubtful debt provision, which may be carried out by one person.

If there is no internal check over this item, it will mean the control risk is high, so the auditor should perform more checks to reduce the level of detection risk and hence achieve the required level of audit risk.

From the discussion above, over these items, it can be seen that the audit risk approach is helpful in achieving an efficient and low risk audit. However, it is difficult to quantify accurately each of the risk elements in the equation, and thus the equation will provide a less quantitative guide to audit work than be apparent from the simple equation

QUESTION FOUR

INVESTIGATIONS

An investigation can be defined as an enquiry commissioned by a client for some purpose of his. The scope of enquiry, the range of possible clients and the number of purposes can be very large. We shall therefore confine ourselves to the most common types of investigations that the professional accountant may be called upon to do.

Common types of investigations:

a) Acquisition of companies;
b) Purchase of business;
c) Prospective investments;
d) Admission of new partners
e) Prospective lending;
f) Fraud;
g) Systems breakdown;
h) Company acts investigation;

Investigations may be needed whenever facts are in doubt or in dispute or where knowledge is required. Anybody can commission an investigation and you will find that companies, individuals, financial institutions and banks, local authorities, the tax authorities can all commission various investigations.

Investigations: the stages

All investigations are carried out in the same way.

Stage 1: instructions from the client

You must always obtain precise written instructions from the client. This must incorporate a very clear view of the aims of the investigation, the scope of the investigation, the degree of the detail required, the degree of secrecy to be observed, and the person to whom the accountant must address his report. At this level, consideration must be given to the resources the client is ready to utilize and the cost of the job, both in terms of money and time.

Stage 2. Professional courtesies

Professional etiquette requires that if investigations are carried out in the affairs of organizations to whom the accountant is not the auditor then the auditors must be communicated with. This is to observe the usual courtesies and to obtain their cooperation.

Stage 3: organization of the investigation

This involves the accountant assessing the aims of the investigation, estimating the time to be taken and the likely costs and ensuring that the appropriate staff will be available.

Stage 4: obtaining the background information

This is particularly important in investigations in acquisition of business. It involves gathering as much background information as possible about the object of the investigation, the size of the industry and its structure, history since commencement, the future prospects, the relevant

legislation affecting that industry, investment information and relevant accounting ratios. This information is usually available from published sources such as government statistics, trade associations and the financial statements.

Stage 5: gathering preliminary information

This information has to be gathered on the subject to be investigated. This information includes the location of the subject, its products, its range of services and its share of the market, key personnel, major accounting control systems and past reports.

Stage 6: preparing the report outline

A report that meets the needs of many accounting investigations is as follows:

Part A: introduction whereby we have references to the instructions given. The object of the investigation must be apparent from the introduction.

Part B: a summary of the instructions must be given.

Part C: a statement of the precise objectives of the investigation and the report

Part D: a statement of the scope of investigation stating the time, period and the area covered

Part E: a statement of the documents use. If it is necessary to reproduce any of these documents this is usually done in an appendix.

Part F: an outline of the work actually done, again it may be necessary to put some of this material in an appendix.

Part G: a summary of the information obtained.

Part H: further information which could be of use to the client but does not flow from the investigation proper.

Part 1: Recommendations of the accountant. In giving recommendations, the accountant must always ensure that:

a) He gives information from which the client can draw his own conclusions
b) Avoid presenting information in such a way that the client's judgment is influenced.
c) If information is based upon assumptions, then the accountant must state the assumptions in full and substantiate them if possible.

d) Make no forecasts
e) If you are giving opinions, estimates or forecasts, then the accountant must state who made them and what qualifications they had to making them.
f) The recommendations are practical
g) The investigation has been comprehensively completed.
h) The report is drafted and discussed with the client.
i) The final report is submitted.

Stage 7: The investigation proper

Stage 8: Drafting and discussing the report with the client

Stage 9: Finalizing and delivering the report

Stage 10: Being available for further inquiries and investigations.

(b) The programmme will involve: -

1. Ascertain the level of authority and the nature of duties of the cashier. In this case, the cashier is responsible for the payment and receipt of cash and the payment of wages and is also the bookkeeper. As such there is a major weakness in the cash system due to the lack of segregation of duties. The cashier carries out all the functions of the cash system (receiving, paying and recording), hence there is no internal check. All this increases the possibility of fraud.
2. Cast and vouch the cashbook and obtain certificates of opening and closing balances from the bank.
3. Check the cash book against bank statements paying particular attention to the dates of lodgment to ascertain whether receipts were banked promptly
4. Examine pay in slips at the bank and compare with counterfoils to reveal teeming and lading.
5. Scan the cashbook for any apparent irregular payments.
6. Examine returned cheques comparing names of payees with the details in the cashbook and invoices
7. Obtain duplicates of missing expenditure vouchers
8. Vouch and cast the petty cash book
9. Confirm all names of all employees shown on payroll with the chief accountant and personnel manager and confirm amounts payable to them.
10. As the cashier is still the bookkeeper then all postings should be checked and a trial balance extracted.
11. Confirm all debts written off, discounts allowed and return of goods
12. Check the order book against the sales daybook, or copy sales invoices in order to detect any unrecorded sales.
13. Vouch purchase invoices with purchases daybook and see that none of them has been processed twice.
14. Obtain duplicates of all missing purchase vouchers.
15. Compare the creditors statement against purchase ledger balances
16. Check goods inwards book or order against invoices to ensure that the invoices relate to genuine purchases.

QUESTION FIVE

(a) 1.Items at an auction are usually sold to the highest bidder and the company should not participate in the auction. In the case of Nyama Safi, the auctioneer firm belongs to the wife of one of the directors and by virtue of that, is a related party to the organization.

Related party transactions are usually subject to terms and conditions that are not applied to arms length transactions.
Therefore the appointment of the auction firm should be put under scrutiny to determine if the appropriate procedures were followed. Again evidence showing that the items were auctioneered need to be examined to determine if the item was sold to the highest bidder or not. If not, then the auction firm should pay to Nyama Safi the difference.

b) This again is an example of a related party transaction. The directors are related parties to the company in which they are directors.

In this case cars were sold to the directors at net book values, which were between the realizable or market values.

The action I would take is to ask, the directors to pay more money to Nyama Safi in order to bring the total amount of money paid to the market value of the cars, failure to which I would encourage the receiver to seize the cars and sell them and refund the directors their money.

Over and above that, I would advice the shareholders to take legal action against the directors for embezzling the assets of Nyama Safi. The directors were supposed to act in the best interest of the company and not to enrich themselves by taking undue advantage of their position.

DECEMBER 2000

ANSWER ONE

(a) Procedures to be undertaken to minimize the risk of a breakdown of the system

1. Have a maintenance agreement with the supplier to regularly service the system
2. Have an independent power supply source to cater for unexpected power failure
3. Safeguard the equipment from hazard such as floods and fire by placing the main computer in a secure room and having other parts of the system insulated
4. If the system requires special atmospheric conditions such as air conditioning or dust free room, make arrangements to ensure that this is complied with
5. Regular back up must be done, probably on a daily basis
6. Arrange with a supplier for a replacement, should it be required so that if certain equipment breaks down, the replacement is available for a period of time.

(b) To ensure that product details on the computers standing data files are correct over the addition amendment and deletion of product details.

i) Special change forms should be designed and either pre-numbered or given sequential numbers by the computer as changes take place.
ii) Selected officers should be the only ones authorized to approve the changes to the standing data.
iii) When changes are proposed they should be collected together and reviewed buy a senior manager or a small committee and approved.
iv) After the changes have been made a print out of the old and new master files should be made and subjected to a manual review to check that the details are correct before the new standing data becomes operational.
v) The computer should be programmed to log or record any changes to product details, particularly recording the name of the persons authorizing the change, the type of change carried out, The time of the change. This log should be reviewed regularly by internal audit and senior management and investigated for any unauthorized adjustments.

(c) Procedures to be undertaken to ensure that prices charges to customers are correct:

1. Establish a proper pricing, policy with an authorized price list being maintained and documented
2. Ensure that the bar codes are for identifying the product on the stock master file otherwise a different selling price master file should be maintained.
3. Regular checks should be carried out by comparing the prices on the shelf with the prices on the master file.
4. Ensure that the cash registers have a screen so that customers can see the prices they are being charged
5. Stock similar items on the same counter, with the most up to date being indicated on the counter rather than on the individual packed items
6. Regular print out should be made of the price file and this should be checked manually for the correctness.

(d) Ensure that the computer records of stock quantities are accurate.

1. Regular stock takes should be organized matching the physical quantities to the records and updating the records to reflect the actual quantities.
2. Establish a re-order level for all items, so that regular print outs from the computer will ensure review of the stock item

3. Quantity reconciliations can be produced by the computer monthly, showing opening balance, receipts, and issues and closing balance for every item.
4. The stock takes can be done on a rotational basis so that stock quantities are monitored constantly.

ANSWER TWO

(a) The first matter for the auditor to quantify the total costs of this type of expenditure. This would be done by examining the costing records of job SPOO1 and checking the accuracy of the attributed costs to underlying documentation. This will involve the cost of the materials, used labor, time and appropriate rates and testing the accuracy and reasonableness of the overhead allocation to the job. Similar work would be required to determine the running costs that have been incurred since the building of the pool.

A further issue raised by this situation is whether there are any other transactions of a similar nature, which need similar consideration. For example, have any of the directors had any building work or house improvements made that have in effect been paid for by the company? Managements written assurances should be sought on this matter and the locations at which Rural Urban Housing work has been carried out during the year should be checked to see if they correspond to the addresses of any of the directors or known related parties.

Assuming the swimming pool is the only example of this type of transaction, the real issue is how it should be treated in the financial statements. The company (presumable through the directors) claims it is used for promotional purposes and the claim must be investigated. The auditor should physically inspect the pool for its existence.

For example:

Does the pool have 'board" displaying rural and urban housing as the builder, and there is promotional literature at the pool?

Is there evidence of prospective clients visiting the pool?

Does Rural Urban Housing promotional literature mention that a pool is available for viewing?
Have any orders for further swimming pools have been obtained from other customers?

Where the answers to these questions support the claims of management then the company's accounting treatment may be correct. The auditor would however have further issues to consider:

Who is the legal owner of the pool? It is claimed to be a company asset, however, if it is on land owned by the managing director (which presumably it is) then in law he would (probably) own the pool and it would be difficult to recognize it as a company asset; and

Whether the managing director could be assessed as having a personal benefit that should be disclosed as part of his remuneration (with possible taxation implications).

Where there is little or no evidence that the pool is being used for promotional purposes, the company's treatment of the pool is incorrect. Neither the capital cost of the pool nor the running costs should appear (as such) in the financial statements. These costs should be treated either as remuneration of the managing director (which would have implications) or they should be reimbursed immediately. Treating them, as a loan would be unacceptable as this would probably be in contravention of the Companies Act.

(ii) Commission payments:

- The issues raised by these payments could be summarized as:
- They may be genuine payments of commission that are unusual in the method of payment
- They may be a form of bribery, which are unlikely to be common practice, and are both unethical and illegal.
- They may not be payments to third parties at all and represent defalcations of cash by directors.

Given the information in the question, the auditor's suspicions must have been aroused and the matter should be probed to the bottom. The appendix of ISA 240 The Auditors duty to consider Fraud in an audit of financial statements contains examples of 'unusual transactions' and 'problems in obtaining sufficient and appropriate audit evidence. Reference is made to inadequate supporting documentation and authorization of transactions and evasive responses by management. These examples appear to describe the commission payments and the existence of these factors increases the likelihood of fraud. The question implies that the management of Rural Urban Housing is reluctant to identify the recipients on the basis that doing so would increase the risk that these valuable contacts may be disclosed to competitors. This is an inadequate response. The auditor has a duty of confidentiality to the client and would not reveal commercially sensitive information of any kind. The auditor should seek written representations from management as to the nature of these of payments. However ISA 580 management representations say such representations cannot be a substitute for other audit evidence where the auditor could reasonably expect it. It seems unlikely that the auditor will be able to discover the true nature of these transactions. In these circumstances the auditor should express a qualified opinion or a disclaimer in his report on the basis of the limitation of scope of the audit. If the auditor is able to conclude that there is a fraud and its effect is material and has not been properly reflected in the financial statements this could lead to an 'adverse' audit report.

Where fraud involves senior management including members of the board, the auditor should consider reporting to an audit committee, if one exists, or taking legal advice. As the last resort the auditors should consider withdrawing from the audit, as there could be no reliance on managements representations.

ANSWER THREE

The procedures that could have been adopted to detect the fraudulent activities of Mr. A. Chiengo would have included the following:

(i) Comparing the source documents to the records and the physical items. For example, capitalized items should have been vouched and physically inspected to confirm existence at the year end. Obviously the auditors did not sight the additions to fixed assets.

(ii) Reviewing for window dressing, the process of selling all stock items just before the year end and repurchasing them shortly after the year end would have disclosed serious cut off problems and window dressing.

(iii) Relating the re-purchases to sales under ratio and trend analysis.

(iv) Comparison with performance in the rest of the industry, as the growth in the company's sales astronomical and not possible to achieve through straight business.

(v) Circularisation of debtors as it would have been unlikely that fictitious sales agents would reply.

(vi) Searching for circumstances that should arouse the auditors suspicion, such as the confidentiality agreement, high bonuses paid to other directors and employment on commission basis.

(vii) Inherent risk assessment that should have targeted the directors competence and integrity.

(viii) Attending a stock take and comparing the records with actual quantities counted.

(ix) Analytical review involving audit risk areas and figures that do not make sense.

The companies Act, Section 162 gives the auditors unrestricted access to the documents, vouchers and accounts of the company. The 'confidentiality' agreement constitutes a very serious breach and places a material scope limitation on the auditors. The auditors would be unable to conclude on the completeness, accuracy and validity of a significant number of transactions and balances.

They will not have received all the information and explanations deemed necessary for the purposes of their audit. This is a ground for qualifying their report. If therefore the auditors had not qualified their report they would have made a big mistake. It is unethical for auditors to accept an engagement under such terms that restricts their scope

(c) An audit is carried out principally to form an opinion on the true and fair view. To form such an opinion the auditor has to obtain sufficient and appropriate audit evidence. The auditor takes full responsibility for his opinion.

Under the provisions of ISA 910, the objective of a review of financial statements is to enable an auditor to state whether on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditors attention that causes the auditor to believe that the financial statements are not prepared in all material respects, in accordance with an identified, financial reporting framework (negative assurance).

Thus an audit has not been carried out and the negative assurance is less assuring than an auditor's report.

(d) Upon legal advice and accepted position within the accountancy profession and legal precedent an auditor would be guilty of profession negligence if:

(i) He does not exercise due care and skill during the performance of his professional assignments or

(ii) He fails to detect material misstatements caused by errors or irregularities including frauds which a reasonably competent auditor would have detected or

(iii) He has performed his audit and failed to comply with approved auditing standards or generally accepted auditing practices or procedures.

Attendance at stock takes, cut off tests reviews for window dressing and debtors circularization as well as physical inspection of addiction to fixed assets are all well accepted and expected auditing procedures.

And whereas the auditor should not go out seeking to discover every fraud or error or other irregularity, once his suspicion has been aroused he should probe the matter in detail to the bottom. Clearly there were glaring indications that fraudulent activity was taking place. That the auditor was not put upon enquiry and that he did not carry out normal audit tests as in (a) above that could have detected the fraud would make it very difficult for the auditor to prove that he has not been negligent.

ANSWER FOUR

INSURANCE CLAIMS

Tutorial Note: this is a question on review engagement which auditors are frequently called upon to undertake as an assurance service. In answering you need to display knowledge of required steps in undertaking this type of assignments as well as the ability to relate to the scenario given.)
As a background, I have given detailed notes on how insurance claims are computed and the type of evidence the auditor would require. This answer for part a is too detailed even for the best prepared student. A tabular approach would be ideal.

An insurance contract may be defined as a contract whereby, a person or a company (the insurer) agrees, in return for a premium, to pay a sum of money to a person or company (the insured) on the happening of a certain event or to indemnify the insured party against loss caused by risk insured against.

Claims for loss of stock
When a fire breaks out, it destroys a number of assets such as buildings, machinery, furniture, stocks etc. These may e insured to reduce financial difficulties of the organization suffering from the loss.

The books of account maintain accounts of all assets except usually the stock-in-trade. This therefore required estimation as to the amount at hand. This therefore requires estimation as to the amount at hand at the date of fire; and thus us accomplished using:

1. Gross profit margin/mark up for previous years adjusted for known changes
2. Records of sales (or transactions with debtors) up to date of fire
3. Records of purchases (or transactions with creditors) up to date of fire.

A memorandum of trading account is drawn in which the period covered is from the first day of the financial year to the last day i.e. the date of fire. The closing stock will therefore be the stock existing at the date of fire, if all other information apart from closing stock (e.g. sales, purchases, etc) is available for the financial period ending on the date of fire, then the closing stock may be worked out as the missing entry using appropriate margins.
Consequential loss (or loss of profits)

When a fire occurs, it destroys or seriously affects the capacity of the firm to do business until its properties are restores. In ability to produce and sell thus results in:

(i) Loss of profit that could have been earned
(ii) Constant (standing) charges non-recovery
(iii) Increased cost of working such as renting other premises temporarily

These losses are called consequential loss. It is possible to take out an insurance policy to cover against consequential losses.
This requires that should a loss occur, a claim may be made, and such a claim will require computation, leading to an estimation of profit lost.
Profit normally depends on sales, and usually loss on profit is computed by ascertaining how much sales have suffered because of the fire. The following definitions are necessary:

1. Gross profit = Net Profit + Insured Standing Charges OR Sales

If loss, Gross profit = Insured Standing Charges – Insured Standing Charge

$$\text{X Net Loss}$$
$$\text{All Standing Charges}$$

2. Net profit: This is the net trading profit (exclusive of all capital receipts and outlay properly chargeable to capital) resulting from the business of the insured at the premises after due provisions has been made for all standing and other charges including depreciation.

3. Insured Standing Charges: Charges that may be insured interest on debentures, loans mortgages and bank overdrafts and rent, rates and taxes, salaries to permanent staff, wages to skilled employees, director's fees, auditor's fees, traveling, license, insurance premiums, advertising and sundry unspecified standing charges (cannot exceed 5% of specified standing charges)

4. Indemnity period: The lower of
   (i) The period for which sales is below normal; and
   (ii) The period specified in the policy
   Indemnity period cannot surpass 12 months from date of fire.

5. Rate of gross profit: The rate of gross profit earned on the turnover during the financial year before the financial year in which the fire took place

6. Annual Turnover: The turnover during the 12 months immediately preceding the fire date.

7. Standard Turnover: The turnover in the period corresponding to indemnity period in the immediately preceding financial year.

Adjustment shall be made necessary to provide for the trend of the business and variations in or special circumstances affecting the business either before or after the damage, so that the adjusted figures shall represent, the results which, but for the fire, would have been obtained during the relative period after damage.

Turnover attained in 12 months just before the fire is called annual turnover.

Procedure for computation of claim:

1. Calculate the short sales by comparing sales made during abnormal period in the year of fire with the sales of the same period in the financial year immediately preceding the fire. It should be noted that:

   (a) Calculation of short sales is to be made for the period of dislocation due to fire or period of indemnity according to policy, whichever is less;

   (b) The sales last year may be adjusted up/down to consider trends, in business growth in arriving at short sales.

2. Calculate the rate of gross profit in the last financial (accounting) year preceding that of the fire. Calculations of gross profits margin for loss-of-profit policy is different from the normal rate of gross profit (Margin). For loss of profits it is computed as follows:

   = Net profit + Insured standing charges or Sales x 100
   * The net profit excludes income from investments etc.

3. Calculate the loss of profit on short sales by applying rate of profit (as computed in step 2) to the sales lost (as computed in step 1). This is the first amount that may be claimed from the insurance company.

4. Add to the lost profit (as per step 3) the increased cost of working:
   This is restricted to the lowest of:

(i) The actual increased cost of working

(ii) Gross profit on annual adjusted turnover x cost of working
Gross profit as above + standing charges not insured

(iii) Gross profit achieved due to increased cost of working

This is simply an application of the average clause to ensure all standing charges are insured. The following alternative formulas may be used:

5. Deduct the amount of expenses due to their being not incurred as a result of non-productive activity.

1. The gross claim can now be subject to the average clause as follows

$$\text{Gross claim} \times \frac{\text{amount of policy}}{\text{Gross profit on annual adjusted turnover of 12 months Immediately preceding fire.}}$$

Notes to the steps in computation

(a) Annual adjustment turnover means the sales for the 12 months ending on the date of the fire adjusted for known charges. If before the date if the fire,

(i) Sales are 10% higher than in the previous year
(ii) Sales for the year ending on the date of the fire is Sh.500,000
then the annual turnover (adjusted) = 500,000 + (10/100 x 500,000)
= 550,000

(b) Gross profit here means the gross profit that would have been earned on the 12 months ending on the date of the fire.

(c) Any change in the basic working conditions giving rise to a change in the gross profit ratio should be taken into consideration. Suppose last year, the ratio was 25% but due to an increase in the wage rates it is expected to decline by 3%. The ratio should be taken to be 22%.

Therefore having obtained the claim for stock I would

(i) Compute the margins for the last five years, based on the audited accounts to 31 December 1999.

(ii) Determine that all other components except closing stock and gross profit for the trading period to 13 June 2000 are pout into the trading account.

(iii) Using an average margin if appropriate check the calculation of the gross profit

(iv) Check that the computerized balancing figure, which is the stock figure, is reasonable.

(b) **ACCOUNTANTS CERTIFICATE**

OMEGA FURNITURE LIMITED
CLAIM FOR LOSS OF PROFITS AND STOCKS

We have reviewed the enclosed claim for loss of profits and stocks resulting from the fire omega Furniture Ltd. suffered on 13 June 2002, which led to the closure of the company's business till November 2002 when it re-opened after rebuilding of the factory.

This claim is the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.
We conducted our review in accordance with the International Standard on Review Engagements 2400 (or refer to relevant national standards or practices applicable to review engagements). This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and an analytical procedure applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying claim does not give a true and fair view in accordance with International Financial Reporting Accounting Standards.

Maungu & Co
Certified Public Accountants.
Nairobi
Kenya

Brief Reason for the wording of the report.

The choice of words mainly aims at informing the user of the review report that this is a moderate assurance engagement and therefore does offer the same level of assurance as an audit.

ANSWER FIVE

a. The composition of the audit committee.

It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non-executive members of the audit committee can be suitably independent may be difficult to achieve.

b. The main objectives usually associated with audit committees include;

i. Increasing public confidence in the creditability and objectivity of published financial information including un audited interim statements
ii. Assisting directors (particularly non executive directors) in meeting their responsibilities in respect of financial reporting
iii. Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards

- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditors examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc
- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

(a) The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

JUNE 2001

QUESTION ONE

(a)

Further procedures to be adopted in order to reach a conclusion on whether the company's system of control can be relied upon include:

1. Obtain copies of the invoices that cannot be traced from the supplier. Compare this invoice obtained from the supplier and the uninitiated one with the related purchase order which was initially sent to the suppliers. Compare this with purchase order with the related goods received note. Confirm the receipt of these goods as evidenced by the goods received note to the stock cards of concerned stocks. If all the above documents are in agreement, this would indicate the validity of the liability or payment, if not, this would indicate a lapse in the internal control system which would affect the extent to which it can be relied upon.
2. Approval of invoices for payment that are not initialised (as evidence of being checked) would indicate a departure from the prescribed internal control. Thus, I would increase my sample size to determine if it is common for invoices to be approved that are not checked.
3. Carry out a walk through test on the altered stock cards by tracing the entries on these stock card to the documents of origin such as:

   - The purchase order
   - The goods received notes
   - The suppliers invoice

   This would help me to determine whether the adjustments were correcting errors or they were fraudently done. I would also make enquiries regarding this adjustment from the responsible officers or employees.
   For the supplier who is paid on the basis of the pro forma invoice.
   I would select a sample of these pro forma invoices and carry out a walk through test by: -

   - Trace the pro forma invoices to their related purchase orders and determine whether the goods were actually ordered.
   - Inspect the related gods received note to determine whether the goods were actually received in the quality and quantity ordered.
   - Trace the pro forma invoice to the proper invoice subsequently received and whether these match the pro forma invoices in every detail.

   Review the agreed trade and payment terms with this supplier.

   Obtain representations from management as to why the unusual method of operating was adopted.

   If the above documents are in agreement with each other, then it means that the prescribed controls work and may be relied upon.

   Part (b) according to ISA 400 and 49 the auditor should make management aware as soon as practical and at an appropriate level of responsibility, of material weakness in the design or operation of accounting and internal control systems which have come to the auditors attention in the course of his audit.

   As such the main purposes of reports to directors or management are for auditors to communicate points that have to their attention during the audit: -

a. On the design and operation of the accounting and internal control systems and to make suggestions for their improvement.
b. Of other constructive advice, e.g. comments on potential economies or improvements in efficiency.
c. On other matter e.g.

- Comments on adjusted and unadjusted errors in the financial statement or on particular accounting policies and practices.
- Details of inefficiencies or delays in the agreed timetable for preparation of the accounts or of working schedules, which delayed the completion of the audit and may have resulted in additional costs.
- Any significant differences between the accounts and any management accounts or budgets, which not only caused audit problems but also detract from the value of management information.
- Any results of the auditor's analytical procedures of which management may not be aware and may be of benefit to them.

The principal limitation of the report included: -

(i) Only those matters that come to the auditor's attention are reported on.
(ii) If the shortcomings point to management weaknesses they are unlikely t be corrected or implemented on a timely basis.
(iii) The shareholders or the regulatory authorities may not receive a copy of this report and thus only one executive director may see it.

QUESTION TWO

1. Nakuru Motor Spares is a material debtor to Nairobi Motor Spares ltd. However the client is of the view that they have obtained a floating charge on the stock of Nakuru Motor Spares hence no need to make a provision

To determine whether a provision is necessary, I will need to take the following factors into consideration:

a) A floating charge is an equitable charge securing a loan on the assets of a going concern. It remains dormant until crystallization. Therefore, the issue is what are the chances that the charge will crystallize? It seems to me that there are high chances of crystallization as the customer, Nakuru Motor is a slow payer and his debt has increased over the year. This should cast doubts on the going concern of Nakuru Spares, as it seems to have difficulty in meeting its current obligations.
b) A floating charge created six months before winding up is void since Nakuru Spares seems to be in financial difficulty, it is worth considering the date the charge was created.
c) A floating charge is subordinate to any specific charge, therefore I would consider whether there exists other charges which are superior to this charge.
d) The charge may crystallize at a moment when Nakuru Spares does not have any items at hand or the stock may be worth less the amount owed occasioning a loss to Nairobi Spares. Again, these stock may need to be resold at a value which cannot be predetermined. Therefore in conclusion a provision is still required due to the above limitations.

2. The occurrence of so many errors indicate that their stock value in the records could be misstated. Many items could be carried at wrong quantities and values. Therefore the auditor should attempt to reconcile the physical count with computerized book stock records to determine the extent of misstatement of the stock value. The auditor may: -

a) If the physical count was reliable, the auditor may use these quantities as the basis of valuing the items. These values would be compared with the latest purchase invoices and if the resultant valuation shows a reasonable comparison with the computer generated values, no provision is necessary. If the differences are material, the auditor should consider whether proper books of accounts are kept or not. If not, this would constitute a limitation on scope. The auditor should then consider whether the limitation of scope is so material and persuasive that a disclaimer of opinion or qualified opinion is call for.

b) Selected number of stock items and check their movements and produce quantity reconciliations.
c) Carry out analytical procedures to determine whether fair values have been attributed to the stocks.
d) Consider whether internal audit carries out regular physical stock counts and the resultant investigations that take place.

3. An increase in the value of stock could be attributed to various factors such as: -

a. Inclusion of stock at wrong values. According to IAS 2, inventories should be valued at the lower of cost and net realizable value. Sometimes management may include stock at their selling prices which may lead to such an increase. To establish items of stock carried at the wrong prices, a line-by-line review may be carried out. The client is unwilling to this, the auditor may carry out analytical review procedures on

- Gross profit margin
- Stock turnover
- Percentage increase in stock value

b. A decline in sales made by the organization hence resulting in a build up of stock. This is definitely a contributing factor for the client as is indicated by the 25% increase on the old stock listing. To determine this, the auditor may attempt to identify movements of stock to see whether there is a slow down in the pace

QUESTION THREE

Tutorial Note
This question requires adequate knowledge of accounting standards, relevant auditing standards and good exam technique. For instance, on the requirements part the word "matters" to consider should alert the student to consider the following matters:

i) **Materiality**
ii) **Audit risk**
iii) **Accounting treatment**
iv) **Fraud and earnings management**
v) **Related parties transactions**
vi) **Ethical issues**
vii) **Legal issues**
viii) **Environmental consideration and industry issues**

From the above list, it is apparent that the accounting treatment predominates and the capability and integrity of management will be put to question.

The matters which should be taken into consideration in answering this question specifically addresses;

i) Accounting treatment prior to the valuation and the motives or goal of valuing the property and equipment at the year end' is it a scheme of earnings management.

IAS 16, plant and equipment requires depreciation to be provided for except freehold land and long leasehold properties (presumably referring to finance leases)

The previous accounting policy was therefore not in accordance with IFRSs and the fact that we are the auditors means that we may be exposed to negligence litigation because the reported profits for the previous years have been overstated. The reasons for not depreciating should be sought.

The decision to sell the wholly let out property to third parties should also be screened to see whether this is not an attempt to massage earnings.

Accounting for leasehold properties in governed by IAS 17 – Leases, and the depreciation provisions of IAS 16 also apply.

ii) The professional valuation
This means a change in accounting policy from the cost model to the fair value model and the provisions of the ISAs need to be applied accordingly. The auditor, in accordance with ISA 545 – Fair Value Measurements and ISA 620 using the work of an expert needs to obtain audit evidence that is sufficient and appropriate as far as the scope of the experts work adequacy for the purpose of the audit. The auditor should also assess the appropriateness of the experts work as evidence regarding the financial statement assertion being considered, in this case valuation.

This involves assessment of whether the substance of the experts findings is properly reflected in the financial statements or supports the financial statement assertions and consideration of source data used assumptions and methods used, consistency with prior periods if applicable.

The auditor should ensure that the values are not related parties.

iii) The financial and economical performance of the firm should also be taken into consideration to assess the objectivity of management

iv) Other relevant assertions such as ownership and obligations, existence

v) Substantive procedures to be performed to confirm all relevant assertions

vi) Reliability of information provided by management

vii) Disclosures required.

QUESTION FOUR

The Finance Director
Industrial and Banking Holdings Limited
P O Box 2411
00202 Nairobi

05 August 2003

Dear Sir

Legal and Accounting Standard Requirements for Subsidiaries

I refer to our discussion regarding the appropriate treatment of the banking subsidiary in the group accounts.

The regulatory framework with regard to subsidiaries consists of:

i) International Financial Reporting Standards (IFRSs)
ii) The Companies Act, Cap 486 requirement, and
iii) Corporate governance and securities exchange guidelines

Under the applicable financial reporting framework in Kenya, the relevant IFRSs are:-

i) IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors.
This IAS governs the selection and application of accounting policies consistency in the application of accounting policies, changes in accounting policies.

ii) IAS 27 – Consolidated and Separate Financial Statement governs the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent.

The methods of accounting for business combinations and their effects on consolidation, including goodwill arising on a business combination are covered under IFRS 3-Business combinations.

IAS 27 defines a subsidiary as an entity including an unincorporated entity such as a partnership that is controlled by another entity known as the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The ISA requires a parent to present consolidated financial statements in which it shall consolidate its investments in subsidiaries.

However, the parent is not required to present consolidated financial statements if and only if;

(a) The parent is itself a wholly owned subsidiary or is a partially owned subsidiary of another entity and its other owners including those not otherwise entitled to vote, have been informed about, and do not object, the parent not presenting consolidated financial statements.
(b) The parent's debt or equity instruments are not traded in a public market (a domestic or foreign exchange or an over-the-counter market, including local and regional markets)
(c) The parent did not file, not is it in the process of filing, its financial statements with a security commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
(d) The ultimate or nay intermediate parent of parent produces consolidated financial statements available for public use that comply with IFRSs.

Since your company is a listed entity, you are required to consolidate the subsidiary under the IFRSs framework.

In case the above exceptions were available, then you would have been required to prepare separate financial statements in which investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5, are accounted for either at cost or in accordance with IAS 39. This same accounting treatment is applied for each category of investments.

A subsidiary cannot be excluded from consolidation simply because the investor is a venture capital organisation, mutual fund, unit trust or a similar entity.
A subsidiary is also not excluded from consolidation because its business activities are dissimilar from those of other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the differences in the activities of subsidiaries. For example, the disclosures required by IAS 14 – Segment Reporting, help to explain the significance of different business activities within the group.

IAS 27 goes further to require the following disclosures to be made in the consolidated financial statements;

i) The nature of the relationship between the parent and the subsidiary when the parent does not own, directly or indirectly through subsidiaries more than half of the voting power.

ii) The reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting power or potential voting power of an investee does not constitute control

iii) The reporting date of the financial statements of a subsidiary when such financial statements are used to prepared consolidated financial statements and are as of a reporting date or for a period that is different from that of the parent and the reason for using a different reporting date or period.

iv) The nature and extent of any significant restrictions (e.g resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances.

In the case of the banking subsidiary, has the same reporting date as the parent and control is direct, only the disclosure in (iv) above may apply.

With respect to the Companies Act, cap 486, Laws of Kenya, Group Accounts are required under section 150 which states that where at the end of its financial year, a company has subsidiaries, accounts statements dealing with the state of affairs and profit and loss of the company and the subsidiaries shall, subject to subsection (2) be laid before the company in general meeting when the companies own balance sheet and profit and loss account are so laid.

The Companies Act allows exclusion from consolidation on the following bases;

1) Group accounts shall not be required where the company is at the end of its financial year the wholly owned subsidiary of another body incorporated in Kenya and;

2) Group accounts need not deal with a subsidiary of the company if the company's directors are of the opinion that:-
   i) It is impracticable, or would be of no real value to the members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to the members of the company or:-

   ii) The result would be misleading or harmful to the business of the company or any of its subsidiaries or;

   iii) The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking and if

the directors are of such an opinion about each of the subsidiaries, group accounts shall not be required;

The requirements of IAS 27 are more stringent than legislation. However, the IFRSs requirements present a more true and fair view and therefore should be followed to avoid qualification of the auditors reports on account of non compliance with IFRSs.

Therefore, in conclusion, the subsidiary should be consolidated and appropriate disclosures made in the financial statements.

Yours faithfully

Maungu & Co
Certified Public Accountants

QUESTION FIVE

The purposes of the auditor sending a management letter:

i. To enable the auditor to give his comments on the accounting records, systems and controls
ii. To enable the auditor to bring to the attention of the management areas of weakness that might lead to material errors
iii. To enable the auditor to communicate matters that may have an impact on future audits
iv. To enable management to put right matters that may otherwise have led to audit report qualification
v. To enable the auditor point out areas where management could be more efficient or more effective or where economies could be made or resources used more effectively.

The contents of the report include:

i. A list of weakness in the structure of systems of accounting and internal controls. This means where the client has records or controls which are ill designed or inadequate.
ii. A list of deficiencies in operation of the records or controls. This is principle good records and controls have been designed but they may be by-passed or not always carried out.
iii. Unsuitable accounting policies and practices
iv. Non compliance with accounting standards or legislation
v. Explanations of the risks arising from each weakness
vi. Comments on inefficiencies as well as weaknesses.
vii. Recommendations of improvement.

Items (iii) and (iv) may require the auditor to qualify his report to the members as required by statute.

The proposal that the report to management by the auditors should be distributed to the shareholders as well as the financial statements has some merits such as:

i. Giving the shareholders more information on how their funds are being controlled and thus giving them increased opportunities for monitoring their investment and checking the performance of the directors. It will alert the shareholders to breaches by the directors of legal and other requirements, items that due to materiality considerations do not appear in the auditors report to shareholders.
ii. Bad investment decisions by the directors and inefficient, uneconomical and ineffective policies of the directors will be highlighted.

On the other hand, the main role of the auditors is not to judge on the ability of the management. Distributing the report to the shareholders would therefore have the following demerits:

i. Allows more conflict between the providers of funds and the controllers stifling possible initiative by the directors, yet the director's performance can easily be monitored through the price movement on the stock exchange.
ii. In most cases a good number of the directors, are themselves shareholders. Thus they are able to act to correct shortcomings on behalf to the rest of the directors.
iii. Too much information to shareholders may counter productive, as the shareholders attention will be detracted from the more important issues.

The current practice is not to send such a management letter to the shareholders, although in certain industries such as banking, building society or insurance, such information is provided freely not only to management but also to the regulatory authorities such as the central bank of Kenya and the commissioner of insurance.

Shareholders in the main tend to be interested in such a report to give their directors some leeway in operations.

DECEMBER 2001

QUESTION ONE

a) According to ISA 200, objectives and general principles governing an audit of financial statements audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The ISA requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.

The ISA states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared in all material respects in accordance with an applicable financial framework.

(i) Audit risk is a function of the risk of material misstatement of the financial statements (risk of material misstatement) (i.e. the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not defect such misstatement (detection risk)

Therefore audit risk has the following components:-
- Risk of material misstatement
  - ✓ Inherent risk
  - ✓ Control risk

(ii) Inherent risk is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

(iii) Control risk is the risk that a misstatement that could occur in an assertion and that could be material either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control. Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to the preparation of the entity's financial statements.

(iv) Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and its application by the auditor.

b) The factors which influence inherent risk in an audit. Factors influencing inherent risk could be internal or external, specific to account balances, transactions, disclosures and presentation or the environment in which a firm operates.
- Complex calculations
- Amounts derived from accounting estimates

External circumstances include technological developments which might make a particular product obsolete.
- Lack of sufficient capital
- Declining industry characterized by a large number of business failures.

c) Audit work to be done to assess the control risk in a purchases system.

Control risk is a component of the risk of material misstatement. ISA 315, understanding the entity and its environment and assessing the risk of material misstatement

Paragraph 7 of the ISA 315 states that the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment including its internal control.

- Inquiries of management and others within the entity
- Analytical procedures
- Observations and inspection

The auditor can also perform other audit procedures where the information obtained may be helpful in identifying risks of material misstatement.

With respect to the purchases system, the audit work will include:-

(i) Inquire from the persons charged with the purchases system and internal audit personnel concerning the design and effectiveness of controls of the purchases system.
(ii) Inquire about the procedures for requisitioning of goods and services by specific personnel on standard specified forms.
(iii) Check sequence of order forms used and whether missing items are investigated
(iv) Observation of operations of the system such as when goods are being delivered and the documentation process.

QUESTION TWO

Note: The dates given in this question are important in answering the question.

The key issues in the question are accounting requirements, audit reporting and subsequent events.

1. Improvements to leasehold premises
   a) Treatment in the financial statements. The authoritative document on accounting for leases is IAS 17 leases. This standard in addition to the provisions of IAS 16, property, plant and equipment, allow for the capitalization of the major improvements and subsequent amortisation over the life of the lease (25 years). This applies to finance leases, not operating leases.

      The premises were vacated on 20th October 2000 when the auditors report had already been signed. The fact that no tenant could be found could mean that the asset was impaired, but this would not make the auditor negligent.

   b) The auditors were not negligent. However, it will depend on whether the plans to vacate the premises and the reasons for the vacation. Was management and auditor aware of plans to vacate the premises.

2. Deferred expenditure on pure and applied research and development costs increased two years previously.
   a) Accounting treatment
      Accounting for research and development expenditure is guided by IAS 38 – Intangible assets.

      ISA 38 defines research as original and planned investigation undertaken into the prospect of gaining new scientific or technical knowledge and understanding. ISA 38 also defines development as the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

      The terms "pure and applied research" refer to sub classification of research expenditure. The organisation for economic co-operation and development (OECD) divides research and development expenditure into three categories;

      (i) Pure (or basic) research: experimental or theoretical work undertaken primarily to acquire new scientific or technical knowledge for its own sake rather than directed towards any specific aim or application.

(ii) Applied research: original or critical investigation undertaken in order to gain new scientific or technical knowledge and directed towards a specific practical aim or objective.

(iii) Development: use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services to install new processes or systems prior to the commencement of commercial production or commercial applications or to improve substantially those already produced or installed.

Given the uncertainties surrounding the benefits of research and development, IAS 38 in principle prescribes that prudence should prevail over the accruals concept in case of conflict.

ISA 38 prescribes that no intangible asset arising from the research/research phase should be recognized and the related expenditure should be recognized as an expense when it is incurred.

An intangible asset arising from development expenditure should be recognized, if and only if an entity can demonstrate the following:-

a. The technical feasibility of completing the intangible asset so that …
b. Its intention to complete the intangible asset and use or sell it
c. Its ability to use or sell the intangible asset
d. How the intangible asset will generate probable future economic benefits
e. The availability of adequate technical, financial and other resources to complete the development and to sue or sell the intangible asset
f. Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

If an entity cannot distinguish research phase and development phase of an internal project, the entity treats the expenditure on that project as if it were incurred in the research phase only.

The deferred expenditure in the question is shown as consolidation of pure and applied research and development costs. If it was not possible to separate research and development phases, then the whole amount should have been expensed in accordance with IAS 38.

If it were possible, then the amounts should have been separated, with the research phase costs being expensed when incurred and the development being recognized as an intangible asset and amortised accordingly.

The production of the product ceased in July 2000, before the audit report was signed. This is an adjusting event meaning that the intangible asset was impaired as at the balance sheet date (refer to IAS 10, Events after the balance sheet date, and ISA 560 subsequent events)

b) Auditors negligence

If this information was available during the audit and when the accounts were being signed, then the auditor may be negligent. He should have discussed the issue with client management for the financial statement to be adjusted or disagreement, modify his opinion.

3. Credit notes totalling 1,955,000.
   a) Accounting treatment

   The authoritative document on provisions is IAS 37, provisions, contingent liabilities and contingent assets.

   IAS 37 defines a provision as a liability of uncertain timing or amount requires a provision to be made when an entity has a present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of obligation. No provision should be recognized if the above conditions are not met.

The sale of faulty goods to customers was an obligating event (constructive/legal) and therefore an estimate of the provision should have been made. Analysis of comparative information should have guided the auditor.

The balance of debtors at the balance sheet date was impaired.

b) Auditors negligence
The auditor could be held negligent for not having done adequate work on the debtors. Circularisation would have helped pick out the customers complaint and its effect on the debtors balance.

4. a) Accounting treatment
Financial guarantees are within the scope of IFRS 4, Insurance contracts. In the case of Jos Ltd, the guarantee is to a company controlled by the directors hence this is a related party transaction which should have been disclosed as per IAS 24, Related parties. As per IFRS 4, the guarantee does not fulfil the definition of an insurance contract because it is not made to a separate entity.

In the separate financial statements of Jos Ltd, disclosure should be made in accordance with IAS 37.

b) Auditor Negligence
The auditor may be negligent depending on whether the information about the guarantee was available and there was no limitation of scope. He should have advised management on the implications of not disclosing to his audit report.

5. Redundancy payments
a) Accounting treatment
The management decision alone is not a past obligation event. According to IAS 37, no provision was to be recognized on the balance sheet date. IAS 37 defines a contingent liability a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from past events but is not recognized because it is not probable that an outflow of resources embodies economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

In the above question, as at the balance sheet date, there was no obligation. However, the implementation took place before the audit report was signed hence disclosure was required under IAS 10. Events after the balance sheet date, which was done.

b) Auditor negligence
The disclosure was in accordance with the applicable financial reporting framework hence the auditor is not negligent.

6. Entertainment and publicity
a) Accounting Treatment
This indicates high risk of misstatements and weakness in the control environment. The fact that there were no vouchers to support the payments should have put the auditor on inquiry and performed further audit procedures in response to the risks.

There is risk of fraud in this context and the auditor should have ascertained whether the expenses were business or personal in nature. If the directors did not account, then the money should ideally be recovered from their remuneration or treated as a loan or advance to the directors till they pay.

The auditor should have insisted on disclosure and adjustments to the financial statements to reflect this anomaly or failure to this, he should have modified his report.

b) Auditor negligence
The auditor can be held negligent for not modifying his audit report when the director failed to adjust the financial statements.

QUESTION THREE

The Managing Director
LF Ltd
P O Box 2411
KHN 00202
NAIROBI

7 December 2001

Dear Sir/Madam

Advise on Accounting for the Deficiency in the Pension Fund

I refer to your request for advice on various issues regarding the deficiency in the self administered defined benefit pension fund.

You have requested that I advise on:

(i) How each of the alternative methods of rectifying the position would match the true and fair view requirement
(ii) Whether the payments should be treated as normal, exceptional, extraordinary deferred or prior year items
(iii) Other matters to be born in mind when considering the three alternatives

I will briefly explain the accounting framework for the defined benefit pension schemes, how the deficiency arose then I will discuss of the three alternatives in them.

Defined benefit schemes are accounted for in accordance with International Accounting Standard No.19, Employee Benefits.

For defined benefit schemes, the actual cost of the scheme has to be estimated and depends on:

a) Employee salary at the date of retirement
b) The proportion of employees that remain with the employer until retirement age
c) The average life span of pensioners
d) The effect of inflation on cost of living adjustments to pensions when paid
e) The performance of the investments

The main issue in defined benefit schemes is that the obligation to pay benefits is recognized as the employees render their services. The actual cost in a given financial period is not likely to match the actual contributions.

The true and fair view requirement demands that costs be recognized as employees render their services and the estimated cost not the actual contribution account for in the income statement.

OPTION 1

To make an immediate payment to clear the difference.

The suitability of this depends on the availability of funds. It may not present true and fair view if the deficit which relates to prior periods is expensed in the current period alone. It may show reduced profitability or fluctuation in performance.

If this option is exercised, it will be necessary to recognize prior period adjustment for the past costs charge in the income statement for the current year costs and a deferred cost for the portion of future costs till the next actuarial review.

OPTION 2

Clear the deficiency by equal payments over the following five years. This spreads out the burden on cashflows and may give a better regard to the true and fair view principle. If this option is exercised, a liability should be recognized and payments offset against it but additional disclosure in the notes to the accounts will need to be made explaining the whole position. A charge in the profit and loss account for the current year costs and deferred costs for the portion of future costs.

OPTION 3

To increase the employers future contributions by a specified percentage. Under this option, the increased amount will have to be split between a prior portion and current portion with a liability recognized for future obligations.

Other factors to be considered include;
- Liquidity position of the company
- The changes in the variables which determine the defined benefit obligation
- The changes or revisions of pronouncements of the applicable financial reporting framework

We are available for further consultations in this matter.

Yours faithfully

Maungu & Co
Certified Public Accountants

QUESTION FOUR

Tutorial Note:
This engagement is a review engagement as opposed to an audit. The objective of a review engagement is to enable the auditor to state whether on the basis of procedure which do not provide all the evidence that would be required in an audit, anything has come to the auditors attention that causes the auditor to believe that the financial statements are not prepared in accordance with an identified financial reporting framework (negative assurance)

The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of ISRE 2400, relevant professional body (ICPAK) legislation, regulation and where appropriate, the terms of the review engagement and reporting requirements.

The information to be sought and the procedures to be performed is as follows:
1. financial statements for the preceding financial period
2. Applicable financial reporting framework including accounting policies
3. The control environment including integrity of management
4. Previously done analytical review results
5. Terms and conditions of the insurance cover
6. The workings of the management for the claims and the report of any experts involved

7. For the loss of profits, obtain from management information on profits that could have been had the constant or standing or fixed, operating costs and the increased cost of working such as renting other premises temporarily.
8. Reports of insurance and relevant government authorities
9. Types of inventory and uses

Procedures to be performed include:-
1. Obtain financial statements for the preceding financial periods
2. Evaluate the accounting policies and methods of valuing and accounting for inventories
3. Consider the consistency and thoroughness of controls on inventory and financial reporting
4. Discuss adjustments done when physical courts are done
5. Calculate operating ratios; gross profit, net profit, insured standing charges, indemnity period, rate of gross profit, annual turnover, standard turnover.
6. Establish the trend of the businesses and variations in or special circumstances
7. Establish the accuracy of the procedures used in establishing the claims
8. Obtain the insurance policies, establish the rights and conditions under the policy and note any exclusions that may affect the client
9. Perform the following steps in obtaining the consequential loss claimed:-
   (i) Calculate the short sales by comparing sales made during the abnormal period in the period affected by the fire with sales of the same period in the financial year immediately preceding the fire or period of indemnity.

   The calculations of short sales are made for the period of indemnity according to policy whichever is less and the sales may be adjusted upwards or down to consider business trends.
   (ii) Calculate the rate of gross profit in the last financial statements preceding the fire
   (iii) Calculate the loss or profit on short sales by applying rate of profit obtained in step (ii)
   (iv) Add the increased cost of working
   (v) Subject the gross claims to any average clause or contributory negligence

For verifying and reporting of the stock:
(i) Based on audited accounts, compute the margins for the previous periods.
(ii) Determine all the other elements of the profit and loss account except closing stock and gross profit
(iii) Using an average margin, checking the calculation of the gross profit, apply the rate to obtain gross profit for the period of interruption
(iv) Check for the reasonableness of the balancing figure, which represents the closing stocks cost.

b) ACCOUNTANTS CERTIFICATE

REVIEW REPORT TO OMEGA FURNITURE LTD ON CLAIM FOR LOSS OF PROFITS AND LOSS OF STOCKS

We have reviewed the enclosed claim for loss of profits and stocks resulting from the fire Omega Ltd suffered on 13th June 2002, which led to the closure of the company's business till November 2002 when it re-opened after rebuilding of the factory.

This claim is the responsibility of the company's management. Our responsibility is to issue a report on these components of the financial statements based on our review.

We conducted our review in accordance with the International Standards on review engagements (ISRE) 2400. This standard required that we plan and perform the review to obtain moderate assurance as to whether the components of the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel

analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and accordingly, we do not express an opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying claim does not give a true and fair view in accordance with International Financial Reporting Standards (IFRSs)

QUESTION FOUR

(a) Based on the information given it appears that P.Shah should consider the purchase a modular integrated accounting packaged and create a small local are network (LAN) of two or three terminals. This will allow the company's systems to be computerized in stages and also facilitate several employees accessing different modules at the same time. Other considerations would be:

(i) It is necessary to consider the cost and benefits of such a decision. Computers and related software are relatively cheap, and even small systems are quite powerful and can improve efficiency considerably. Higher costs may be in form of pressure on staff due to retraining or possibly recruiting new staff.

(ii) It is advisable to purchase both the hardware and software from the same company as this would reduce compatibility problems and determine who will be responsible for correcting them. The supplier should be a well-established company with a good reputation. Similarly it would be advisable to purchase a well known and tested packaged rather than a new product that may be fully debugged. Such packages should be capable of being upgraded at a later date, say to incorporate stock control. Also, reputable software companies will provide regular revisions to modules, for example when the tax/national insurance rates are altered.

(iii) The specification of the package should be assessed for adequacy. The number of sales, purchase and nominal ledger accounts that the package supports must be sufficient for existing requirements and allow for future expansion. Other facilities such as the provision of aged debtors/creditors reports and the ability to interrogate the system and generate one off reports should be available. It is important that the package can be integrated with other software that the company may use (e.g. databases and spreadsheets). The package should contain reasonable security measures including the use of structured password protection

(iv) As it seems that the staff of P.Shah Manufacturing Ltd may not be familiar with computers the supplier should be willing to provide adequate training and help line facilities. This may influence the selection of the package. User-friendly applications employing graphical interfacing are now commonplace and are easier for staff to learn. Such systems use a windows environment with menus, icons and a mouse to drive them.

(v) It would be beneficial to both the auditor and the client if the auditor was already familiar with the product selected preferably based on past experience with other clients. However the auditor has to remain independent and he must be careful to ensure that he does not make executive decisions for the company.

(vi) The packages ability to provide an acceptable audit trail is important to the auditor.

(vii) A maintenance contract which includes back-up or stand-by-facilities should be purchased

(b)

Although this is a continuing audit the changes caused by the computerization make it similar to the planning required for a new audit.

The auditor should consider whether he has the technical knowledge and skills required to perform the audit. Auditing in a computer environment does not require additional skills to a manual accounting audit.
However all audit firms should have sufficient knowledge of data processing to handle this type of audit work.

At the planning stage it is important to consider the effect the computerization will have on the nature and particularly the timing of the audit work. It may be better to advise the directors to computerize the whole of the accounting system (with effect) from the beginning of the current year. This would have the following advantages

- The opening balances for debtors, creditors and other balance sheet items will be scheduled in great detail and they will have already been tested and verified by the auditor. This would save considerable time and expense by not having to do this partway through the year.
- It avoids the complexity of part of the years audit being on a manual system and the other part on a computerized system. Otherwise this may require different staff having to be involved in the audit.
- From both the company and auditor's point of view there would be a built-in 'parallel' run as the accounting transactions of the early part of the year will have been recorded manually. These can be compared to the same period for the computerized system to verify its accuracy.

The auditor should consider the type and timing of testing he will perform. Many computerized systems are tested by the use of Computer Assisted Audit Techniques (CAATs). These normally take the form of audit software that can 'interrogate' the computers data files and the use of test data (test pack) which is processed by the system and the results compared with a known outcome. Such techniques may not be available or may be too expensive to develop for the package Shah Manufacturing Ltd intends to use.

In this case the auditor would have to rely on more traditional techniques based on auditing 'round' rather than 'through' the computer. A problem is that the year-end information that is vital to the auditor is transient in a computer environment. So it is necessary to be in attendance at the client's year end to ensure that ledger accounts, including balances of debtors, creditors and other balance sheet figures are printed out and a copy of the transaction data files are produced at this time. If necessary, the auditor can' restore' the year-end data to perform, audit tests. In practice it is safer to do this on the auditors own system (assuming he has a duplicate system programme) to avoid any potential corruption of client data.

A consequence of the change is that the auditor will need to revise much of the audit documentation, particularly the audit programme, the assessment of the system of internal control, and file copies of sample documents generated by the new system.

(c)

The impact of information technology is rapidly affecting the auditing profession. The speed and size of computer processing power allows greater volumes of data to be held and manipulated leading to greater reporting of financial information, much of which is likely to require consideration by the auditor. Modern auditors must possess the technical skills to both control and take advantage of these developments. The following are some of the changes that information technology is having on the auditing profession:

(i) Many audit firms now have 'automated' working papers. These are generally held on PCs and can perform, amongst other things, the following tasks.

1. Internal control questionnaires can be filled in on a PC. The system can highlight any incomplete sections and thus any areas of weakness.
2. Analytical tasks such as ratio calculation, selection of sample sizes and the generation of random numbers.
3. CAATs are becoming more sophisticated with a consequent improvement in the quantity and quality of generated audit evidence leading to greater audit efficiency.

4. The development of 'expert' or 'decision support systems' allow junior audit staff to make judgmental decisions using knowledge gained by experienced staff. These are still in the development stage but can give guidance on materiality issues, automation of checklists, tax calculations etc.
5. Modern computers are changing the working pattern of many staff improvements in portable 'note book' computers and the possibility of world wide data transmission via telephone wires, fibre optic cable and even satellites mean that auditors can be in touch with, and have access to information at the office from anywhere in the world. Many staff now work between home and client's premises and rarely visit the office.
6. A less appreciated aspect of the impact of computers is that many audit firms are recruiting staff who have a data processing background in preference to a pure audit/accounting background. So it is essential that accountants maintain a thorough understanding of computer environments.

Other aspects of the progress in information technology are:

- Security, passwords and PIN numbers are now being superseded by much more secure methods of access. Smart cards and biometrics technology allow access based on voice, palm and even retina recognition. Such techniques are expensive and still in development and are only used in very secure/classified applications;
- The increased use of networking facilities is enabling accounting records to become almost 'paper-less'. This can create serious audit trail problems;
- The use of the INTERNET is beginning to impact on auditing. Some audit firms have established 'web' sites to market their services, thus portraying a hi-tec image, whilst some public companies are considering publishing their annual financial statements on the INTERNET;

It seems that in the future only imagination will limit the possibilities that advances in information technology may bring.

QUESTION FIVE

1. It should be obvious to any prospective auditor that the management of Twenty Second Century Ltd could lack integrity, given the circumstances of the previous auditors dismissal and the 'opinion shopping' procedures adopted by them. Thus, the quality control procedures adopted by the prospective firm would include the determination of the client's integrity.

   The quality control procedures therefore which should be adopted by a firm of auditors when accepting a new client with potentially high audit risk such as Twenty Second Century Ltd are as follows:

   (i) Request the client's permission to communicate with the previous auditor. If permission is refused, the auditor should decline the nomination.
   (ii) On receipt of permission, the previous auditor should be requested to furnish all information which would enable the prospective auditor to decide whether he is prepared to accept nomination. In the case of Twenty Second Century Ltd, the prospective audit firm may enquire of any reason that the firm might have to question the integrity of the prospective clients management.
   Further information would be required about the reasons for the audit qualifications and the dismissal of the previous auditors.
   (iii) Enquire informally of the client's business associates whether they feel that the management of the company is competent and trustworthy.

(iv) Contact the regulatory authority with responsibility for overseeing the sector, if this is applicable, in order to see if any disciplinary measures have been taken against the company.

(v) Make a preliminary assessment of audit risk. This would be undertaken by discussing business and economic matters with the client, and by making a preliminary assessment of the internal control structure of the client. In the case of Twenty Second Century Ltd, the previous auditors had qualified the audit report because of poor internal controls and lack of audit evidence. Thus, it would be important for the audit firm to make a preliminary visit to the prospective client in order to gain first hand experience of the management and the accounting system.

(vi) Assess whether the audit firm has the required expertise to carry out the audit. The audit of land developers is quite specialized and experience in the sector is important if the audit is one of high audit risk.

(vii) Evaluate the costs and benefits of acceptance of the client. The risk of potential legal liability and loss of public image may make the appointment relatively unattractive.

2. There are several ethical issues involved in the maintenance of a secret expense account for the company by the audit partner. First, the audit partner has not behaved with integrity and objectivity. Integrity implies not merely honesty but truthfulness. He has not been open with the board of directors of the company because he concealed the secret expense account from them. Secondly, the audit firm would not be seen to be independent even though in dealing with the transactions in this secret expense account he may have possessed a true mental state of independence. Third parties would doubt the partner's independence irrespective of whether or not the partner acted independently. Objectivity can only be assured if the partner was, and was seen to be independent. Thirdly, in the case of a large public company, a practice should not participate in the maintenance of the accounting records. The auditor should not assume a role equivalent to that of an employee of a client.

   The key consideration in this case is the fact that J.Prescott and the audit partners kept the expense account secret from the management of the company. It would appear to an observer that the two persons were colluding in order to at best, conceal information and at worst defraud the company. From a third party, viewpoint the auditor would not be seen to be independent and it would render the audit opinion somewhat less meaningful.

3. In recent years, many companies, who have disagreed with their auditors over an item in their financial statements, have asked another audit firm for their view on the matter and if the view is sympathetic, then the company invariably has changed its auditors. This practice of 'opinion shopping' could be minimized by adopting the following procedures:

   (i) Where an auditor is dismissed, the company could be required to file a statement to that effect with the Registrar of Companies stating any disagreements with the former audit firm.

   (ii) The audit firm who succeeds the former auditors could be required to disclose also to the Registrar and/or in the first audit report whether or not it agrees with the former audit firm.
   The above points could deter companies from attempting to find audit firms who are prepared to express a more flexible attitude to accounting issues

   (iii) Where an audit firm is approached by a non-client to give a technical opinion on a matter, it is important that the firm has a clear and comprehensive understanding of the issue prior to giving an opinion.

   The audit firm should correspond with the non-clients own audit firm in order to obtain all the information at hand. If it appears that the non-client is 'opinion shopping' then the audit firm should consider its ethical position and possibly refuse to give an opinion.

(iv) Existing legalization gives auditors the right to present their case to the members against removal either verbally at a general meeting or in writing prior to their removal. Similarly where an auditor resigns from his office, he may make a statement regarding the circumstances of his resignation which must be sent to the registrar and every person entitled to receive a copy of the financial statements. However, auditors seldom publicize their point of view when being dismissed for fear of being branded 'controversial'. However, if audit firms were prepared to publicize their viewpoint more forcibly the adverse publicity might dissuade company directors from finding a more co-operative audit firm. Also the prospective auditors would possibly be dissuaded from accepting the appointment, if greater publicity was given the circumstances behind the previous auditors dismissal.

4. Audit firms can reduce the risk of litigation and its effects upon the audit practice by adopting the following procedures:

1. Ensuring that all audit engagements follow Auditing Standards.
2. Establishing quality control procedures and practice standards of the highest quality.
3. Adopting rigorous client acceptance procedures.
4. Ensuring adequate professional indemnity insurance.
5. Developing a positive litigation strategy. Audit firms often have actions brought against them, which would fail in a court of law. Historically some firms have made nominal 'out of court' settlements in order to avoid publicity but others have refused to deal with this type of lawsuit in this manner choosing to go to court and allegedly this has discouraged potential plaintiffs.

JUNE 2002

QUESTION ONE

THE STOCK SYSTEM

The stock system can very important in an audit because of the high value of stock or the complexity of its audit. It is closely connected with the sales and purchases system.

Control considerations

2.2 Stocks may be as susceptible to irregularities as cash and, indeed, in some circumstances the risks of loss may be materially higher. Arrangements for the control of stocks should be framed with this in mind.

2.3 The stock control procedures should ensure that stocks held are adequately protected against loss or misuse, and are properly applied in the operations of the business.

2.4 Stock should be duly accounted for by appropriate recording and authorization of all movements.

2.5 It is also important that the business has proper control over stock levels to prevent on the one hand the possibility of running out of stock and on the other of holding too much stock, and hence incurring increased holding costs and the risk of stock obsolescence.

A further aim should be to ensure stock is appropriately valued, and that write-downs of stock are kept to a minimum.

According to the nature of the business separate arrangements may be necessary for different categories of stocks, such as raw materials, components, work in progress, finished goods and consumable stores.

Other controls:

1. Segregation of duties;
2. Custody and recording of stocks received
3. Checking and recording of goods inwards
4. Precautions against theft
5. Misuse and deterioration
6. Restriction of access to stores
7. Controls on stores environment (temperature, precautions against damp)
8. Control of stock levels
9. Maximum stock limits
10. Minimum stock limits
11. Maintenance of stock records
12. Stock ledgers
13. Bin cards
14. Transfer records
15. Arrangements for dealing with returnable containers
16. Security over stock held by third parties, and third party stock held by entity.
17. Stocktaking
18. Regular stocktaking
19. Fair coverage
20. Counts by independent persons
21. Recording
22. Cut-off for goods in transit and time differences
23. Reconciliation of stock counts to book records and control accounts
24. Computation of stock valuation

Accord with IAS 2
Checking of calculations

25. Review of condition of stock

    Treatment of slow-moving, damaged and obsolete stock
    Authorization of write-offs
26. Accounting for scrap and waste
27. Control considerations: cash at bank and in hand-receipt
28. Segregation of duties between the various functions listed below is particularly important.

(b) Receipts by post

1. Safeguard to prevent interception of mail between receipt and opening
2. Appointment of responsible person to supervise mail
3. Protection of cash and cheques (restrictive crossing)
4. Amounts received listed when post opened
5. Post stamped with date of receipt

Control over sales of and collections

1. Restrictions on receipt of cash (by cashiers only, or by salesmen etc)
2. Evidencing of receipt of cash

    - Serially numbered receipt forms
    - Cash registers incorporating sealed till rolls

3. Clearance of cash offices and registers
4. Agreement of cash collections with till rolls
5. Agreement of cash collections with banking and cash and sales records
6. Investigation of cash shortage and surpluses

Recording

1. Maintenance of records
2. Limitation of duties or receiving cashiers
3. Holiday arrangements
4. Giving and recording of receipts

    - Retained copies
    - Serially numbered receipt books
    - Custody of receipt books
    - Comparisons with cash records and bank paying in slips

Paying into bank

1. Daily banking
2. Make-up and comparison of paying-in-slips against initial receipt records and cashbook
3. Banking of receipts intact/control of disbursements

Cash and bank balances

1. Restrictions on opening new bank accounts
2. Limitations on cash floats held
3. Restrictions on payments out of cash received
4. Restrictions on access to cash registers and offices'

5. Independent checks on cash floats
6. Surprise cash counts
7. Custody of cash outside office hours
8. Safeguarding of IOUs, cash in transit
9. Insurance arrangements
10. Control of funds held in trust for employees
11. Bank reconciliation's.

- Issue of bank reconciliation's
- Frequency of reconciliation's by independent person
- Reconciliation procedures
- Treatment of longstanding unpresented cheques
- Stop payment notice
- Sequence of cheque numbers
- Comparison with cashbooks.

QUESTION TWO

According to the framework for preparation and presentation of financial statements, going concern is a fundamental assumption whereby it is assumed that; -

(i) The entity will continue in operation in the foreseeable future
(ii) The entity has is neither the intention nor the need to liquidate or curtail materially its scale of operations

Thus, the going concern assumption assumes that the company will be able to discharge its operations normally and meet its financial obligations as they fall due.
In the case of a given company, the factors that could indicate that the going concern assumption may be put into question can be described as follows; -

1. **Inability to pay the creditors on the due dates.**
   Major suppliers could withdraw credit or demand cash on delivery. This could mean that as the company maybe unable to collect its debtors as quickly as it is required to settle its liability then it will be unable to meet financial obligations as they fall due.
2. **Excessive holding of stocks and debtors**
   Cash is what pays liabilities and not other assets therefore, inability to collect cash or to convert stock and liabilities to cash could lead to inability to pay creditors.
3. **Use of short term finance for example overdraft to finance long term assets e.g. fixed assets or** research and development on new products, a company can still be in a net asset position but due to the unrealisability of fixed assets still find that its not a going concern as it has no readily realizable assets to pay off its current liabilities.
4. **Use of expensive finance or being highly geared.**
   Few entities are able to achieve gross profit margin of over 50%, expensive finance e.g. Hire purchase, lease hire or company being highly geared means that the interest expense can reduce the margin such that little is left to finance other costs. Use of expensive finance also indicates inability to obtain normal credit and overdraft facilities.
5. **Over trading**
   A company growing too fast may find itself unable to finance the necessary investment in finance and stock holding.
6. **Dependence on one supplier, customer product or market.**
   This means that insolvency or loss of such suppliers or collapse of market for the product could precipitate crises that could lead to the death of the company.
7. **Long term loan reaching maturity without realistic chances of obtaining alternative financing.**

Such loans are usually secured on significant and indispensable assets of the company thus if new facilities cannot be negotiated quickly, the entity may lose its productive facility as they are sold to settle the liability.

8. **Receiving losses**
   Eventually a loss making company will run out of money thus have going concern problems.
9. **Dividend arrears**
   Shareholders not getting a return on the investment will eventually withhold their support for the company and may not subscribe for more equity.

(B) ISA 570: - Going concern. The auditors should assess the adequacy of the means by which the directors have satisfied themselves that:

(a) It is appropriate for them to adopt the going concern basis in preparing the financial statements and

(b) The financial statements include such disclosures, if any, relating to going concern as are necessary for them to give a true and fair view.

For this purpose:

(i) The auditors should make enquiries of the directors and examine appropriate available financial information and

(ii) Having regard to the future period to which the directors have paid particular attention assessing going concern, the auditors should plans and perform procedures specifically designed to identify any material matters which could indicate concern about the entity's ability to continue as a going concern.

Preliminary assessment

The auditors approach includes a preliminary assessment, when the overall audit plan is being developed, of the risk that the entity may be unable to continue as a going concern. The auditor should consider:

1. Whether the period to which the directors have paid particular attention in assessing going concern is reasonable in the entity's circumstances and In the light of the need for the directors to consider the ability of the entity to continue in operational existence for the foreseeable future.
2. The systems or other means (formal or informal), for timely identification of warnings of future risks and uncertainties the entity might face.
3. Budget and/or forecast information (cash flow information in particular) produced by the entity, and the quality of the systems (or other means, formal or informal in place for producing this information and keeping it up to date.
4. Whether the key assumptions underlying the budgets and/or forecasts appear appropriate in the circumstances. This should include consideration of:

   - Projected profit;
   - Forecast levels of working capital;
   - The completeness of forecast expenditure;
   - Whether the client will have sufficient cash at periods of maximum need;
   - The financing of capital expenditure and long-term plans.

5. The sensitivity of budgets and/or forecasts to variable factors both within the control of the directors and outside their control.
6. Any obligations, undertakings or guarantees arranged with other entities (in particular, lenders, suppliers and group companies) for the giving or receiving of support.
7. The existence, adequacy and terms of borrowing facilities, and supplier credit.

8. The director's plans for resolving any matters giving rise to the concern (if any) about the appropriateness of the going concern basis. In particular, the auditors may need to consider:

   - Whether the plans are realistic;
   - Whether there is a reasonable expectation that the plans are likely to resolve any problems foreseen; and
   - Whether the directors are likely to put the plans into practice effectively.

The nature and scope of the auditor's procedures will depend on the circumstances; the extent will depend mainly on the excess of the financial resources available over the financial statements required:
The auditors and directors procedures can be very simple in some cases, particularly in the case of smaller companies, where budgets and forecasts are not normally prepared and no specific systems are in place to monitor going concern matters.

The auditor's examination of borrowing facilities

The auditors will usually:

(a) Obtain confirmations of the existence and terms of bank facilities; and
(b) Make their own assessment of the intentions of the bankers relating thereto.

These procedures will become more vital in any of the following circumstances (for example).

1. There is a low margin of financial resources available to the entity
2. The entity is dependent on borrowing facilities shortly due for renewal.
3. Correspondence between the bankers and the entity reveals that the last renewal of facilities was agreed with difficulty, or that, since the last review of facilities, the bankers have imposed additional conditions as a prerequisite for continued lending.
4. A significant deterioration in cash flow is projected
5. The value of assets granted as security for borrowings is declining
6. The entity has breached the terms of borrowing covenants, or there are indications of potential breaches

If the auditors cannot satisfy themselves then, in accordance with the audit reporting standard (ISA 700) they should consider whether the relevant matters need to be:

1. Disclosed in the financial statements in order that they give a true and fair view and/or
2. Referred to in the auditors report (by explanatory paragraph or a qualified opinion).

QUESTION THREE

(a) Profit and loss account

1. Carry out ratio analysis. I would compare the following ratios and compare the rations with previous years ratios and the industry average: -

   - Gross profit margins
   - Other operating ratios such as mark up.

3. Review the accounting policies used in preparing the profit and loss account and assess whether:

   a. They are consistent with the International Accounting Standards and the generally acceptable accounting policies (GAAPS)
   b. They are applied consistently from year to year.

4. Inspect the items within the profit and loss account to determine their identity for example:

   Sales - search for fictitious sales. Review of the sales daybook and cashbook and cash sales will identify fictitious sales.
   Expenses or purchases -review suppliers statement and trend of payments made.

5. Visit a number of the business premises to assess the volume of business actually being achieved.

(ii) Balance sheet

1. Carry out ratio analysis. I would compute the following ratios.

- Fixed assts turnover ratio
- Current ratio
- Acid test ratio
- Stock turnover ratio
- Debtors average collection period
- Creditors payment period.

2. Consider the validity of the entries in the balance sheet for example: -
   Stock- assesses the existence and conditions of stock (by carrying out a stock take) and its apparent value.

   Debtors - circularize debtors to assess their existence value

   Creditors - circularize them to identify any unrecorded liabilities.

   Fixed assets - inspect them to confirm their existence and condition and determine whether they have been denied necessary repairs and maintenance.

3. Review the accounting policies adapted for these items to determine their suitability and consistency of application.

   The factors to consider on whether: -

   i. To purchase all the shares are:Is the company well known by its given name and is his significant businesses derived from the use of the name? If so, then shares should be purchased.

   - The quality of the company's assets
   - Contractual arrangement of Nathoo with third parties.

   ii. To purchase assets, goodwill, and liabilities: -

   - Level of liabilities. If high, then it's better to purchase only the assets.
   - If there is no goodwill, because the company's reputation is poor, it is better to buy the assets and operate under a new name.
   - Continuity of trading arrangements. Some contracted arrangements lapse or need to be renegotiated when ownership of the company changes. As such, the name of the company has no real value and the assets and goodwill can be bought without the name.

QUESTION FOUR

Point of sale terminal is a generic term for various types of devices used in retailing business to capture sales and inventory data.

An electronic point of sale comprises of a range of electronic devices e.g. Personal computers, barcode scanners etc that is used to capture sales and inventory data at point of sale terminal. Point of Sale is wide spread in supermarkets (like this company), which need regular information on stock positions and stocktaking. Point Of Sale provides information that includes.

- Sales by item (stock code)
- Sales of stores
- Fast moving stock items
- Slow
- Hourly/daily sales
- Purchases by customers
- Sales by staff/till location
- Transaction type, cash, debit, credit cards.

Advantages over the previous system (general)

1. Provides faster means of data capture as scanning is faster than keying in.
2. Less labor intensive. Prices don't have to be laboriously attached to items as they are held on the master file record.
3. Reduced level of errors, as transcription errors are minimized.
4. Provides automatic inventory update.
5. Better customer service - customers are served quickly
6. Availability of accurate and complete information for management's decision making.

Specific advantages to debtors

1. Sales orders can be routinely checked by the systems and authorized if they fall within the customers credit limits.
2. Automatic reconciliation of the sales ledger to the control account. Any differences could be printed out for investigation
3. Immediate postings and sales invoices and receipts from customers and credit notes
4. Aged debtors listing would be updated by the minute, hence bad doubtful debts will be easily identified and recommended for write off or provision.

Specific advantages to stock

1. Highlighting differences between goods ordered as per purchase and goods received. This is possible because the system automatically matches the two documents when keyed in by staff.
2. Facilitates comparison of stock records (which are updated) against physical quantities to detect any differences, which could be as a result of pledges and breakages.
3. Purchase orders can be automatically generated by the computer when sock records reach the reorder level.
4. Slow moving, obsolete items, those reaching expiry dates and those held in excess quantities can be easily determined and printed out.

Specific advantages to cash and cash controls

1. Receipts and internal remittance advice can be generated automatically as customers pay.
2. Easy to analyze the total receipts into cash, credit notes from cash sales.

QUESTION FIVE

(a) An auditor may be liable for damages for material misstatements in published accounts on which he has expressed an audit opinion in the following circumstances: -

1. His failure to detect error and fraud;
2. Carelessness or dishonesty on his part or by his audit assistants.

However, he may avoid liability by;
Planning and carrying out audit procedures that will provide him with a reasonable expectation of detecting all material misstatements.

Again, it may be a defense to show;

1. There was no negligence
2. That no duty of care was owed to the plaintiff in the circumstances
3. In the case of actions in tort, that no financial loss has been suffered by the plaintiff.

(b) A successful, legal claim be brought against the auditor by: -

1. His client, whom he owes a primary duty of cane
2. To third parties under the law of tort to assess the value of damages, the tort will consider the following:-

1. It must be proved that the auditor was actually negligent
2. That out of his negligence the plaintiff suffered a financial loss.
3. That the auditor owed a duty of care to the plaintiff.
4. Whether the financial loss is material to warrant redress.

c) Ways of limiting an auditors liability; -

1. Incorporation of the audit practice

This has already been done in the United Kingdom. For example, KPMG incorporated its UK practice. However in Kenya, this is prohibited by law.
These arrangements create a "firm within a firm". KPMG audit plc is a limited liability company wholly owned by the partnership. This is done in order to protect partner's from the crushing effects of litigation. Thus, KPMG Audit plc fences the personal assets of each partner, protecting them from the negligence of a colleague working on an audit.

Under this arrangement, partners involved directly in an audit can still be sued, but incorporation should prevent other partners from losing everything they own simply because they work with someone who has been negligent.

Incorporation will however impose statutory disclosure required on accountancy firms, which have been able in the past to avoid producing published accounts because of their partnership status.

This greater degree of openness can be seen in a more positive light. Clients will be able to see the first position of one of their most important service providers.

2. Limited liability partnerships

An alternative means of limiting the risks faced by the accountancy profession is allowing partnerships limited liability.
If such a law is passed, the change in law would protect partners, personal assets from negligence claims against another partner. The firm's assets and those of the allegedly negligent partner would still be exposed to liability.

3. Avoiding or disclaiming liability to third parties (non statutory works)

A duty of care to a third party may arise when an accountant does not know that his work will be relied upon by a third party, but only knows that this work of a kind which is liable in the ordinary course of events to be relied upon by a third party.
Conversely, an accountant may sometimes be informed before he carries out certain work that a third party will rely upon the results. An example is a report upon the business of a client, which the accountant has been instructed to prepare for the purpose of being shown to a potential purchaser or potential creditor of
that business. In such a case, an accountant should assume that he will be held to owe the same duty of care to the third party as to his client.
One way that the accountants may seek to avoid liability to third parties is to limit access to his work or reports. For example:

(a) When publishing documents generally an accountant may find it advantageous to include in the document a clause disclaiming liability. For example; "while every care has been taken in the preparation of this document, it may contain errors for which we cannot be held responsible"
(b) When submitting unaudited financial statements or reports to the client, an accountant should ensure that any special purpose for which the statements or reports have been prepared is recorded on their face and in appropriate cases should introduce a clause providing that the report or statement is confidential and has been prepared solely for the private use of the client. For example; - "This report (statement) has been prepared for the private use of X (the client) only and on condition that it must not be disclosed to any other person without the written consent of Y (the accountant)
(c) There are areas of professional work (for example when acting as an auditor under the Companies Act), where it is not possible for liability to be limited, or excluded. There are other areas of professional work (for example when preparing reports on a business for the purpose of being submitted to a potential purchaser) where although such a limitation or exclusion may be included, its effectiveness will depend on the view which a court may subsequently form of its reasonableness.
(d) The investor's view of the reliability of the audit opinion may be attended by the limiting of an auditors liability.The investors may be of the opinion that an auditor's opinion may be given recklessly because his liability is limited, thus, they may not consider it as reliable as when the auditors liability was not limited.There will be no effect on the work to be performed by the auditor. This is because the auditor's work is governed by statutes, auditing standards and professional guidelines that have not changed with the limited auditors liability.

Therefore the auditor's opinion will still be as reliable as before.

(e)

- Yes. It is practical for the auditor's liability to be limited. However, the extent of liability can only be determined by a court of law in the case of a legal suit.
- There will be not effect see (d) (ii)
- Yes. I agree that the auditor's liability should be limited. Why? Because the public as a result of misunderstanding the role of the auditor have been bringing cases of negligence against them indiscriminately.

DECEMBER 2002

QUESTION ONE

To carry out starters and leavers test, I will select two payrolls, the first at the start of the company's financial year and the second a recent payroll. I will note:

1. Employees not on the first payroll who are on the second payroll. These are starters.
2. Employees on the first payroll who are not on the second. These are leavers.

For both starters and leavers, I will go to the personnel department and find the date each employee started or left.

For starters I will check to the relevant payrolls that they were not paid before they started employment. For most employees, the first payment should be at the end of the week or month they started work and not for the previous week or month. For manufacturing employees, the first payment should be made the week after they started work and they should not be paid at the end of the week they started work.

For leavers I will check to the relevant payrolls that they were not paid after they ceased employment. For most employees, they should be paid at the end of the week or month they finished work but not for the subsequent week or month. For manufacturing employees, the last payment should be the week after they left employment and they should not be paid in the following weeks payroll.

An alternative way of performing this test is to start from the personnel records of staff who have started or left during the period. I will check that starters have not been paid before the period. I will check that starters have not been paid before they started employment and leavers have not been paid after they left employment in the same way as that described in the two paragraphs above.

If I find any problems, I will discuss them with the company's management. If I detect a fraud, this will require further investigation and I should report it to the company's management and include it in my management letter. This will suggest there should be greater controls over preventing frauds over starters and leavers, such as the personnel department periodically checking the wages department are treating these types of employee correctly.

(b) I will carry out the following audit procedures when I attend the pay out of wages to employees:

1. Before the wages are paid, I will take a copy of the payroll and check there is a pay packet for each employee. If the pay packet is transparent, it may be possible to test check the money in the pay packet agrees with the net pay on the payroll.
2. When the employee is given his/her wage, he/she should sign for it. The signature should be test checked to the employee's signature kept by the personnel department. I will mark on my list when each employee collects his/her wage.
3. I will check that no employee receives more than one pay packet or one for another employee. I will note if this is happening.
4. At the end of the wages payout, I will check that there is a wage packet for each employee who has not collected his/her wage. These will be the unmarked items on my payroll list. These are unclaimed wages.
5. I will check that these unclaimed wages are recorded in the unclaimed wages book. The information recorded in the unclaimed wages book should include the payroll date (and

payment date, if different), the employees name and umber, and the net wage. I will note cases where unclaimed wages are not recorded in the unclaimed wages book.

This is not unusual, as frequently wages collected in the day of payment are not recorded in the unclaimed wages book, and the unclaimed wages book records only those wages, which are unclaimed at the end of the day. This creates a weakness in the wages payment system (although it is minimized by the employees signing for their wages).

As indicated above, one of the purposes of attending the wages payout is to check the existence of employees.

C) In checking the procedures over unclaimed wages:

1. I will have checked procedures for recording unclaimed wages in the unclaimed wages book in part (b) (v) above. To qualitatively check that the same procedures are carried out in the weeks when I did not attend the pay-out. I will check the number of unclaimed wage packets is about the same each week. If they are significantly less in other weeks, this indicates that some unclaimed wages are not recorded in the unclaimed wages book. If I am concerned that proper procedures have not been followed in other weeks, I will ask the company's staff if the procedures are different in other weeks and I may attend another pay-out of wages. I will report the matter to the company's management and include it in my management letter.
2. I will check there is a wage packet for each recorded in the unclaimed wages book.
3. Where employees have collected their wages, I will check that they have either signed for the wage or there is a letter from the employee authorizing another person to collect the wage packet (e.g. when the employee is ill). I will check the employee's signature to the personnel records.
4. The company should pay into the bank wage packets which have been unclaimed for more than a month. The date the wages are banked should be recorded against details of each wage packet in the unclaimed wages book. For a sample of bankings of unclaimed wages, I will check that the amount banked (per the cash book) agrees with the total net wages of the employees as recorded in the unclaimed wages book.
5. If there is a long delay before the wage packets are banked (e.g. over three months), I will report it to the company's management and I may include it in my management letter.

I will report any weaknesses I find to the company's management. The unclaimed wage packets should be kept in a secure place, such as a sage. Ideally, unclaimed wages should not be dealt with by employees in the wages department, and there should be an independent check (probably by the accounts or personnel department) to ensure that proper procedures are carried out and there is no fraud.

(d) To verify the existence of employees, I will first select a sample of employees from the most recent payroll. The procedures I will use for checking the existence of the employees will include:

1. For employees at head office and at sales branches, my audit firm visits, I could go and see them and ask for a signature which would be checked to the personnel records.
2. Employees could be checked to the personnel records, as being currently employed by the company. The question says the personnel department is independent from the wages department.
3. Department managers could be asked to sign a list of employees who work for them and return it directly to me.
4. If the employees are paid by cheque, the cheques could be inspected before they are given to the employee or sent to their bank.
5. Other evidence of employees will include expense claims signed by the employee and records of tax and national insurance. For instance, there could be notifications from

the Inland Revenue of changes in tax code, and there will have been an annual return to the Inland Revenue (at the end of the tax year) which lists each employee.

Based on the results of these test, I will decide whether all the employees on the payroll actually work for the company. It should be noted that the checks above are the variety of methods which can be used to verity employees on the payroll and in practice not all of them would be used.

QUESTION TWO

Inherent risk is the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes of transactions irrespective of related internal controls.

Therefore, inherent risk is the risk that items will be misstated due to characteristics of those items, such as the fact they are estimates or that they are important items in the accounts.

1. As an audit manager, I will use my own professional judgment and all the available knowledge/information to assess inherent risk.
2. As regards the takeover, I will consider whether the provisions managers' assessment of inherent risk is reasonable regarding the sundry accruals and provisions.If there was information that was not available to the profits manager and is now available, for example provision for management bonuses, I will consider the impact of this information on his assessment of inherent risk. If a lot of information is not available (e.g. as regards provision) this would increase the level of inherent risk.
3. My audit approach would be determined by the extent of reliance that I would be able to place on the work carried out by the previous audit manager. If I am satisfied with his approach, I may continue with it and arrive at a conclusion or I would have to carry out my own tests.

Even if I place reliance on the previous audit manager's work, I would still have to carry out some substantive procedures and compare my results with those of the previous manager. If they agree, I would be persuaded to place reliance on his work.

(b)

1. Accruals have been verified by inspecting supporting documentation of (60% of the value of accruals) accruals over Sh.60, 000. Thus, this is not representative of the accruals figure and further tests need to be done on the other 40% on a test basis. If analytical procedures are carried out, and the 2001 and 2002 figure are compared, it will be seen that there was a significant drop. This could be an indicator that some accruals have been left out. Thus further work should be done to test for completeness of accruals
2. The reason given by Mr. Chege does not seem to be reasonable for the decrease in provision. This is because, even if the employees may not carry forward the leave, they are entitled to their leave pay. Thus, I will ensure that the provision takes into account the unpaid leave pay for the other employees.
3. IAS 37 prohibits, companies from creating a provision for maintenance expenses on the grounds that these expenses are avoidable. Thus, this provision needs to be realized to the profit and loss account by: -

   DR provision for maintenance

   CR profit and loss accounts.

4. I would consider the reasonableness of the estimated costs. If it is an overprovision then I would require the directors to write off the overprovision and set up only the required amount, as prudence would dictate.

5. This provision is not justified. This is because credit notes are accounted for in the period in which they arise and not necessarily the period in which the sales were made. Thus. I need to discuss with the directors the need to reverse this provision by: -

   DR provision for credit notes,
   CR profit and loss account.

6. Mr. Chege's argument that the list of director's bonus is confidential is not acceptable. This is because according to Companies Act, the auditor has a statutory right of access to all books and records of the company. Thus, I would demand from him such a list, which I would use to determine the reasonableness of the provisions. If he refuses to give the list I would seek other evidence.

If not available, I will have to consider whether lack of the list consisting a limitation in the scope of my work and if so, I would give a qualified opinion i.e. a disclaimer.

QUESTION THREE

(a) The auditor's responsibilities in the periods listed in the question are given IAS 560 (subsequent events)

1. In the period 31 October to 6 December 2002, the auditor should carry out sufficient appropriate audit work so that he/she has a reasonable expectation of detecting and quantifying material subsequent events. Examples of the types of audit procedures carried out are included in part (b) of this answer.
2. In the period 6 December 2002 to 19 December 2002 the auditor's responsibilities are the same as in the period (a)(i) above.
3. The period from 19 December 2002 to 5 January 2003, the standard says that the auditor should reasonably expect the directors to inform him/her of any material subsequent events detected in this period, which may affect the financial statements. During this period auditors do not have any obligation to perform procedures or make enquiries regarding financial statements.

   When the auditor becomes aware of material subsequent events in this period, he/she should carry out appropriate audit procedures to determine whether the subsequent event has a material effect on the financial statements.

   If the directors amend the financial statements, the auditor should produce a new report on the amended financial statements.

   If the directors do not amend the financial statements, and the subsequent event is material, the auditor should consider how the shareholders can be informed of the subsequent event. This may include the auditors making a statement at the annual general meeting at which the financial statements are approved by the shareholders. The auditor may consider taking legal advice, and it points out that auditors do not have a statutory right to communicate directly in writing to shareholders.

4. In the period from 6 January to 28 January 2003, the auditors have no duty to seek out whether any material subsequent events have occurred in this period. However, if the auditor becomes aware of a material subsequent event in this period, he should consider whether he should withdraw his audit report. He will probably have to take legal advice on the matter. Also, he should discuss the problem with the company. It may be necessary for either the directors or the auditors to make a statement at the annual general meeting (AGM)

   If the directors revise the financial statements, the auditor will have to audit these revisions and come to a conclusion on whether the revised financial statements show a true and fair view. The audit report on the revised financial statements should refer to the note in the

financial statements which describes the changes and it should refer to the earlier audit report. The audit report on the revised financial statements should not be dated before the date the directors approve those financial statements (normally, the dates are the same).

If the directors do not revise the financial statements, and do not make a statement at the AGM, the auditor should take legal advice on the course of action he should take. Normally, he should make a statement to shareholders at the AGM.

5. IAS 560 does not provide guidance on the auditor's responsibilities after the financial statements have been approved by members at the annual general meeting. However, it does appear that the auditor has no responsibility for detecting subsequent events in this period. If, during this period, the directors find material mis-statements in the audited financial statements, and inform the auditor of the fact, the procedures will be the similar to those described in part (a)(Iv) above.

(b) The audit techniques which involve checking subsequent events include:

1. Checking cash received from debtors after the year-end to check recoverability of year-end and sales ledger balances. Any year-end balances which are unpaid at the time of the audit will be potential bad debts and further investigations should be carried out.
2. A debtor's circularization carried out after the year-end could be a post balance sheet check of debtors at the year-end.
3. Checking sales after the year end to check recoverability of stock at the year end, if for stock held at the year end, the selling price after the year end is more than cost, then the stock can be valued at cost. However, if the selling price is less than cost, this stock should be valued at net realizable value.
4. Checking sales cut-off. Starting from the dispatch note, for sales before the year-end, the sales invoice should be posted to the sales ledger before the year-end. For sales after the year-end, the auditor should check the sales invoice is not posted to the sales ledger before the year end (technically, only this latter check is a check of subsequent event).
5. Checking purchases cut-off. Starting from the goods received before the year-end, the purchase invoice should either be posted to the purchase ledger before the year-end or included in purchase accruals at the year-end. For goods after the year-end, the purchase invoice should be neither posted to the purchase ledger before the year-end nor included in purchase accruals at the year-end.
6. Checking supplier's statements to the balances on the purchase ledger. If the balances agree, this is good evidence that the purchase ledger balance is correct. If there is a difference, it should be reconciled and the auditor should consider whether the differences are reasonable. Supplier's statements are an effective way of checking purchases cut-off, and of detecting late issue of cheques after the year-end.
7. Check any sales or disposals of fixed assets after the year-end. This will check whether these assets have been sold for more or less than their balance sheet value. If they are sold for less than their balance sheet value, normally they should be written down to their realizable value at the year-end.
8. Checking returns of goods from customers and other sales credit given after the year-end. This helps determine whether the provision for these items in the financial statements is reasonable. Similar checks can be made for purchase items, such as goods returned before the year-end when the credit is received after the year-end, and other credits received from suppliers after the year-end.
9. Checking about legal claims against the company, which exist, at the year-end. This will involve asking the company secretary and the directors if there are any claims, and (with the clients permission) asking the company's auditor, inspecting board minutes (see item (x) below) could highlight any claims against the company. The bank letter may include details of a claim against the company of Companies House may have some information (but this is uncommon).

10. Checking board minutes and management reports after the year-end, which relate to events at or before the year-end.
11. Checking management accounts after the year-end for any items, which should have been included at the year-end (e.g. bad debts, stock write-downs etc.)
12. Checking cashbook and petty cash transactions after the year-end to see if there are any unrecorded accruals and prepayments at the year-end, and to confirm those items in the financial statements. For instance, receipts after the year end may indicate sundry debtors at the year end and payments after the year end may highlight sundry creditors and accruals which existed at the year end (e.g. the payment of tax and national insurance in November would be good evidence of the liability at the year end.
13. Checking purchase invoices received after the year-end. Some of these may relate to pre-year end transactions (i.e. those which are dated before the year end). Purchase invoice for electricity received after the year-end are an effective way of determining the accrual at the year-end.
14. Checking the bank reconciliation to check if payments were actually made before the year end and there is no teeming and lading fraud (see answer to question 3(a). If there is a delay in clearing a significant value of cheques issued before the year-end, this indicates the actual payment (i.e. when the cheques were sent to the creditors) was made after the year-end. A delay in lodging cash received into the bank indicates a teeming and lading fraud. The fact that the cashbook balance can be reconciled to the balance on the bank statement is good evidence that the cash book balance in the financial statements is correct.

(c) As no detailed audit work would have been carried out during the period, there is a risk that material subsequent events may have occurred in this period. Thus, the auditor will have to ask the director's and senior management, if any material subsequent events have occurred in this period or whether further evidence is available for uncertainties existing at 6 December 2002. Also the auditor should examine such documents as Board and Management minutes, management accounts and seek further evidence relating to uncertainties at 6 December 2002 (e.g. whether a doubtful debit at 6 December has been settled).

QUESTION FOUR

1. Stock valuation

The finance director's claim that the issue of the report after balance sheet date is a non-adjusting event is irrelevant. As at balance sheet date the material could not be used in road construction. In accordance with its value, at the lower cost and net realizable value was 2 million. The issue of the report failed to change the situation. The value of stocks and operating profit should therefore be reduced by the amount of the write down to net realizable value being 5 million. This amount is material being in excess of 10% of operating profit.

If the company fails to adjust its financial statements, the effect on the auditors report would be an "expect for – disagreement" qualification as the matter affects only stock valuation and is therefore not pervasive. The opinion would be headed "Qualified opinion arising from disagreement about accounting treatment". The first paragraph in this section should describe the nature of the disagreement and quantify the effect on the financial statements. The second paragraph would then express the qualified opinion.

(b) Depreciation

Accounting for depreciation requires that useful lives of assets be reviewed regularly and the depreciation adjusted where there is found to be a change in useful life. The finance directors claim that technological obsolescence need not be taken into consideration is not consistent with depreciation for the current financial year should be adjusted so as to write off the written down value of computer controlled earth movers over their revised useful life.

Year of purchase	Cost	Depreciation to 1/1/98	`Written down value 1/1/98	Remaining useful life in years including 1998	Required depreciation charge for 1998 on an overall basis of 5 years <000	Depreciation provided 1998	Adjustment required
1995	5,000	1,500	3,500	2	1,750	500	1,250
1998	8,000		8,000	5	1,600	800	800
							2,050

The depreciation charge should be increased by 2,050,000, which would have the effect of reducing the written down value of plant and machinery and of operating profit by that amount.

If there were no other uncorrected errors I would probably accept the amount as not being sufficiently material to justify issuing a qualified audit opinion. If the financial statements were not adjusted it is just over 5% of operating profit but depreciation is based on an estimate of the useful economic lives of the assets. As such it is not a precise amount and on a qualitative basis does not indicate the financial statements are necessary materially misstated.

If there were other detected but uncorrected errors in the financial statements then no matter how small these other errors might be it would probably be appropriate to qualify my opinion on the financial statements along the same lines as in the case of stock valuation.

(c) Contingent liability

A threat to claim for damages might be regarded as remote but the actual issue of a must be taken seriously if successful the claim would be certainly be material being in excess of the years profit. There certainly appears to be some substance to be the claim and the existence of the lawsuit should be disclosed in the note on contingent liabilities. This note needs to be reasonably comprehensive as to the basis for the claims the amounts involved and the company's grounds for not making a provision.

If the company does not disclose the existence of the claim then an except for - disagreement audit qualification is required. The opinion would be headed qualified opinion arising from disagreement about disclosure. The first paragraph in this section should describe the nature of the disagreement. The second paragraph would then express the qualified opinion.

A further concern is that the existence of the lawsuit might constitute an inherent uncertainty the potential effect on the company as a going concern leading to it being regarded as pervasive. The auditor might need to take legal advice on the potential consequences of the Ministry's investigation. Depending on this advice it may be necessary to add a paragraph to the basis of opinion section of the auditors report with a subheading 'fundamental uncertainty'. This would refer to the note on contingent liabilities in the financial statements of the company continues to refuse to disclose the contingency to the opinion section of the auditors report.

QUESTION FIVE

(a) Considering each of the matters listed in the question

(i) Generally there should be little effect on the auditor's independence in providing taxation services to the client. Most audit firms will have staff with specialized skills in taxation, so they should provide a good service. Also, there should be a cost saving compared with employing another firm for this service, as some of the procedures in preparing and auditing financial statements are helpful in calculating the corporation tax liability (e.g. fixed asset

schedules, analysis of entertainment and some other expenses). Frequently, audit firms will have different staff responsible for audit work and taxation computations, and this will tend to increase independence. The auditor's independence may be slightly compromised if a dispute arises between the company and the Inland Revenue or if the auditor has made a material mistake in the corporation tax computation.

The risks with preparing and negotiating directors tax liability with the Inland Revenue are slightly greater. A director may not have all benefits in kind, or the auditor may not have given the correct advice on a technical matter or a dispute may arise with the Inland Revenue. These problems are likely to create deterioration in the relationship with the director, so the auditor may 'back down' on a contentious issue in the financial statements, in order to maintain good relations with the directors and thus continue as auditor. Ideally the taxation computations should be performed by staff independent of the audit staff, and then checked by the audit staff.

(ii) Many small companies do not have staff with the skills to prepare the financial statements. The auditor has these skills, and there is likely to be a time (and cost) saving if the audit firm both prepares and audits the financial statements.
However, if the same staff both prepare the financial statements and audit them, there is a greater risk that material errors will not be detected, as one is poor at detecting one's own mistakes. Also, staff may feel the item has been audited when preparing the financial statements, and this could lead to aspects of the financial statements being audited unsatisfactorily. So, it is desirable (and recommended) that different staff should prepare the financial statements from those who audit them.
Even in this situation, there is likely to be a cost saving, as the staff preparing the financial statements should prepare schedules which will help in the audit (e.g.) schedules of additions and disposals of fixed assets, and calculation of accruals and prepayments). If the audit firm prepares the financial statements, the letter of engagement for this work should point out that the client should accept that the accounting records are the responsibility of the company, and that the financial statements are based on the company's records and explanations received from employees and the directors.

In conclusion, the provision of accounting services is unlikely to have any significant adverse effect on the auditor's independence.

(iii) The auditors may be quite good at advising on internal control systems, as this is an important aspect of audit work. However, if the auditor's recommendations are implemented and the system proves to have weaknesses (which may result in serious errors or fraud), the auditor may be reluctant to criticize the system (as he would be criticized himself) so his independence would be compromised. For this reason, auditors should not say how internal control systems should be set up in client companies.

However, as a result of audit work, auditors can become aware of weaknesses in internal controls in accounting systems. They should point out these weaknesses to the client, and any errors or fraud, which have taken place. In addition, they can suggest how the systems can be modified to improve controls. The auditor can suggest changes to parts of systems, but they should not say how a whole system should be set up (e.g. a purchases system).

(a) Considering the points raised in the statement:

1. The statement that non-audit fees charged by auditors are similar to audit fees is accepted.
2. There is some evidence that audit fees charged to listed companies may be reduced because of fees the auditor will receive for other services. However, it is very difficult to prove this is happening. If non-audit work is very profitable, then an audit firm may charge a lower audit fee. This is because the auditor has a greater chance of obtaining

non-audit work from the listed company (i.e. audit firms tend to have a higher proportion of non-audit consultancy work than those firms which are not the company's auditor). So, if more "high profit" work is available, the auditor may be prepared to reduce the audit fee to increase the chances of obtaining the non-audit work.

3. The reason why it is difficult to prove that audit firms are reducing audit fees is that one cannot quantify the audit fee required for a particular audit assignment. A replacement auditor may charge a lower audit fee, but this could be because the audit is carried out more efficiently, or the previous auditor had carried out more work that was necessary.
4. There does seem to be a greater risk that the auditor will compromise his independence if he obtains fees from both audit and non-audit work, than if he obtains fees exclusively from audit work. If the audit firm is replaced as auditor, the audit fee and most of the fees for non-audit work will be lost. As non audit work is likely to be more profitable than audit work, the 'pain' to the auditor of losing the audit will be greater, as he will lose the high profit non audit work and the relatively low profit audit work.
5. Risks to the audit firm of being replaced as auditor are often as a result of qualifying the audit report. The client may accept some 'technical' forms of qualification (e.g. not depreciating freehold buildings), but the client will not want the audit report to contain other forms of qualification (for even an explanatory paragraph in an unqualified report can be an indication of going concern problems). Because of the substantial loss of fees, the auditor may back down and give an unqualified audit report.

   If there is a serious risk that the auditor will be sued for not qualifying the audit report, he will probably not 'back down' to pressure by the company. The auditor will want to avoid negligence claims, as they involve a lot of staff time in defending them, it adversely affects the auditor's reputation, and there will be damages to pay if the auditor loses the case (or settles out of court).

   Although the auditor should be covered by professional indemnity insurance (PII) for legal costs and the sum paid in damages, he may have to pay an excess (e.g. the first 25,000 or 100,000 of the claim), and it is likely that future premiums for PII will increase following a claim.

6. Statement (iii) is logical, as reluctance to qualify the audit report is the outward evidence that the auditors independence has been compromised.

The provision of other services by audit firms is likely to benefit both the client and the audit firm. This is because the fee charged is likely to be lower, as the audit firm already knows the client firm and does not have to spend time getting the know the company's business, its employees and systems. With the close relationship between the audit firm and the company, the company's staff should have a good appreciation of the strengths of the audit firm and be able to use these strengths in non-audit consultancy work. The higher profitability of non-audit work, and the better chance of obtaining this work, because you are the auditor, means that obtaining a client with a considerable amount of non-audit work is very attractive to the audit firm.

However from the discussion above, it appears that the provision of non-audit work could adversely affect the independence of the audit firm in carrying out the audit. Technically, the audit firm is appointed by the shareholders, and the auditor reports to the shareholders. It does seem that the provision of other work creates a conflict of interest in the auditor's relationship with the shareholders. If the auditor is reluctant to qualify his audit report, the auditor is not acting in the best interests of the shareholders (and other users who rely on the financial statements).

The arguments for and against allowing auditors to carry out non-audit services for clients are finely balanced. However, listed companies have a large number of shareholders and their financial statements are relied upon by a large number of organizations. Thus, auditors of listed companies have enornomous responsibilities when reporting on the financial statements. It is

against the interest of these people that the auditor's independence could be compromised by the provision on non-audit services. So, on balance, it appears that the final statement of the quotation, "that auditors of listed companies should be prevented from providing other services to client companies should apply".

Note:
As stated above, the argument for and against auditors providing non-audit services are finely balanced. Candidates will not be penalized if they come to different conclusions, based on a suitably argued case.

JUNE 2003

ANSWER ONE

(a) Preliminary Considerations

Acceptance of Engagement
The International Standard on Assurance Engagements no. 3400 states that before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:
• The intended use of the information;
• Whether the information will be for general or limited distribution;
• The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions;
• The elements to be included in the information; and
• The period covered by the information.

ISA 3400 adds that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

(b) **The main points to be considered in conducting the review**

(i) **Nature and background of the company's business**
Establish its activities, products, customers, markets, labour force, prospects, and the trends of its financial results.

(ii) **Accounting polices**
Establish the accounting policies adopted for interim and final accounts and forecasts. Ensure that they are reasonable and are consistently followed especially in the forecasts. Special areas to be watched include stock and work in progress valuations, depreciation, the method of taking profit on long term contracts, exceptional and extraordinary items and deferred tax.

(iii) **The assumptions**
- These should be stated
- The forecast should be consistent with the assumptions which may be economic (e.g. growth in G.N.P.), financial (e.g. interest rate movement), marketing (e.g. market share), industrial (e.g. output potential), labour relations (e.g. strike free periods) etc.

The accountant is not concerned with the correctness of these assumptions although he should be sure the directors are responsible for them and that they are reported on by the advisers.

(iv) The procedures adopted by the company to prepare the forecasts
The accountant should investigate:
- Whether forecasts are regularly prepared for management or prepared only for this occasion
- Whither the recasts are best estimates, honestly believed to be achievable, or simply targets
- The extent to which forecasts for wholly or partly expired periods are covered by reliable interim accounts.

- The extent to which the forecasts are built up form detailed divisional or activity based sectional accounts, distinguishing those woith steady performance foam those with more volatile results
- The treatment of material, extraordinary, and exceptional items
- The adequacy of provisions for future losses and contingencies
- The adequacy of working capital. If finance will be required to fulfill the forecast, this should have been arranged and confirmed.

The report

This will be addressed to the directors and will contain:

(i) A statement that the reporting accountants have carried out a review of the accounting bases and calculations on which the profit forecasts have been based.

(ii) Specific identification of the forecasts and documents to which the report refers.

(iii) If, as likely, the accountant have not carried out an audit of the results of expired periods, a statement to that effect.

(iv) Whether in the opinion of the reporting accountants the forecasts have been properly compiled on the basis of the assumptions made by the Board of Directors, as set out in the prospectus or circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

(v) If the accountant has material reservations about any part of the forecast they should qualify their report.

c. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.

ANSWER TWO

The Directors
Kenya Computer Sales Ltd.
P.O. Box 12345 004000
Nairobi

Dear Sirs

Re: INTERIM MANAGEMENT LETTER

1.0 **INTRODUCTION**

In accordance with our normal practice we wish to bring to your attention certain matters that have come to our attention during our interim audit visit. These do not represent an exhaustive list of all weaknesses that may exist in the systems of accounting and internal controls.

Our report is a draft report and we hope that you will review it and append your management comments to enable us to finalise our report.

2.0 The issue we came across, implications and our recommendations for improvement

2.1 **Credit limits**

We noted that the credit limits for four customers have been substantially exceeded and that new customers in the last twelve months had not been allocated credit limits.

Enforcing credit limits reduces the incidence of bad debts. Conversely when credit limits are exceeded or not established the company's liquidity position is adversely affected.

We recommend that credit limits be carefully established and then once established they should be enforced. When necessary that the limits be revised then proper formalities should be followed and the extension be approved by senior management.

Management comment:

2.2 **Purchases invoices**

We came across a situation where an invoice from a supplier had been posted twice to the suppliers ledger card.
We also were unable trace two other purchase invoices that had been credited to suppliers accounts.

These discoveries raise the possibility that there a fictitious charges and invoices being introduced into the system. The company runs the risk of paying for services or goods not received not ordered for

We recommend that for the acquisition of goods there must e raised a purchase order, when the invoice is received it must be checked against the purchase order and the goods received note before it is entered into the records. All invoices should be validated before payment and the cheque should be supported by invoices. All claims that cannot be supported by invoices should be rejected for payment.

Management comment:

2.3 **Missing stock items**

We attended the half year stock take and the following discrepancies came to our attention

(a) Some microcomputers that were supposed to be in stock were missing and
(b) Some microcomputers returned by customers and in stock had not been recorded as retuned
(c) Some of the missing computers had been borrowed by the directors and some other staff for personal use at home.

The clear risks that arise include the overstatement of sales if the computers were returned and the related invoices had not been reversed. Also the stocks would be materially misstated because items that should be in stock are actually being used by staff. Furthermore the stocks or which no record exists could then be misappropriated and sold, thereby the company suffering more loss.

We recommend that the company puts in place proper measures to protect the stocks from misuse and other deterioration. The company should maintain full stock records so that the movements of all stock items are closely monitored to guarantee proper use of the company's resources.

Management comment

2.4 **Leasing agreements**

The Kenya Revenue Authority have queried the terms of the lease agreements. In their view these are hire purchase agreements since the customers have the right to purchase the equipment at a future date. We have vetted these agreements in the past and agreed with your treatment. Our position has not changed and we shall take it up with the Kenya Revenue Authority.

The risk is that additional assessments may be raised by the Kenya Revenue Authority.

We recommend that the chief accountant immediately commence an analysis exercise of the position depending on the two different scenarios. In this way we will be able to assess the exposure.

Management Comment

3.0 **Conclusion**

These are the weaknesses that came to our attention. There may be other weaknesses that we did not detect. We request that you critically consider these points and append your comment where indicated on the draft.

Having incorporated your comments we will then release the letter formally.

Should you require any clarification please do not hesitate to contact us.

Yours truly

Turn & Feya
Certified Public Accountants (Kenya)

(b) The possible impact these matters may have on the year end work

(i) The concern over credit limits being exceeded or not fully enforced means that audit effort must focus on the adequacy of the provision for bad and doubtful debt at the year end audit visit as well considering the company's overall financial position, particularly insolvency.

(ii) Creditors could be materially overstated having non-genuine liabilities recognized. The existence of creditors will be an area of audit focus at the year end visit

(iii) The valuation and existence of stocks at the year end will be key areas of audit.

(iv) The potential exposure to additional assessments will be of concern to the auditors. If possible all efforts should be made to resolve the matter before the year end so that any outstanding matters can be considered.

ANSWER THREE

(a) The purpose of analytical procedures is to assist the auditors determine whether before he undertakes any detailed substantive tests the figures produced by the accounting system appear to make sense. Figures make sense when they are in accordance with expectations.

(i) It is ordinarily expected that the gross profit margin remains steady year on year. When it increases it arouses the auditors suspicion that any of the components of the gross profit may be materially misstated, sales, opening stocks, purchases, closing stocks. It could also suggest a charge in sales mix, with those products that generate a higher margin increasing in sales.
Audit tests of details will therefore focus on the following aspects

- Occurrence and measurement of sales revenue
- Completeness of recording the purchases expenses and other direct cost and indirect overheads fir absorption into stocks
- The appropriate carrying amount being attributed to closing stock
- The sales mix achieved during the year

(ii) Ordinarily one would expect that if purchases increase by x% over the previous year then closing stocks also increase with a comparable percentage change therefore it stocks now represent 35% of the purchases compared with 25% of the previous year the increase in stocks in percentage terms is far much greater than the corresponding change in purchases. This is not in accordance with expectations, stocks could be materially overstated. Such an increase indicates a decline in demand for the products of the company. A decline in demand means that the risk of obsolescence is greater.

As such audit effort will be focused on the existence of the stocks and the adequacy of the provision for obsolete, damaged and slow moving stock items.

(iii) 30% decrease is a major change in the trend of purchases. When it occurs in the last month of the year the auditors question whether there is a deliberate management attempt at window dressing or presenting the results in other than a true and fair one.
There could be a material understatement of purchases and liabilities

Accordingly the audit tests of details will focus on the completeness of purchases and creditors. There will be a comprehensive search for unrecorded liabilities at the balance sheet date.

(b) Final
Before signing the auditor's report the partner responsible will perform a final review. This will involve:

(i) Ensuring that all audit work has been completed and the evidence is sufficient to support the expression of an opinion

(ii) Ensuring that the view shown by the accountants as a whole is true and fair for this deal with

- Accounting policies
- General review
- Presentation and disclosure
- Compliance with regulation
- Conclusions

It is of fundamental importance that the review be4 performed by someone with a thorough understanding of the business and with sufficient audit experience to make sound judgments. It is probably best done by someone who has not been involved heavily in the conduct of the audit and can therefore; view the accounts with a fresh mind.

Accounting policies

On a basic level, the accounting policies adopted should comply with IAS s, be consistent from year to year and within the entity, and be properly described in the statement of accounting polices as discussed above. Furthermore, the policies should conform to those appropriate for the industry and where there are no specific accounting standards, have substantial authoritative support.

More importantly, the accounting policies adopted should be those appropriate to disclosing a true and fair view. Particular attention must be given to circumstances where:

1. Compliance with accounting standards may be inconsistent with truth and fairness
2. Policies previously adopted may, because of changing circumstances or simply because their previous use was mistake, not necessarily be the most appropriate. In such circumstances consistency should not be adhered to.

The following International Accounting standards are likely to be of particular assistance

1. IAS 1 Presentation of Financial Statements
2. IAS 18 Revenue Recognition
3. IAS 23 Capitalization of Borrowing Costs

General Review

It is important to conduct a final analytical review on the accounts in their format for publication. This includes analytical reviews and other review.

Presentation and Disclosures

When the accounts are in the format in which they are to be presented to shareholders the auditor must look at the presentation as a whole. This will include in particular, the working of notes and other descriptive disclosures. Most of the audit effort will have been devoted towards verifying the numbers yet the impression conveyed by the accountants depends as much on the presentation as on the numbers themselves. The auditor must be satisfied that the impression a reader would obtain from the accounts is consistent with the conclusions reached in the audit. The presentation should not be unduly influenced by management's desire to show matters in a favourable or unfavourable light.

Compliance with regulations

Most auditors use a checklist to confirm that all matters required to be disclosed by the Companies Act and by IASs and other applicable regulations are properly dealt with in the accounts with respect to the Companies Act. Disclosure requirements are contained in: Schedule 6 – particulars in company accounts dealt with and other transactions favouring directors and offices.

Conclusion

On compliance of the final review the auditor should be in a position to form an opinion on the accounts.

The final review of the financial statements

The work we have considered so far has shown that the auditors first gathers facts about the enterprise and the environment it operates in. The next stage was the gathering of audit evidence

about individual items which together form the accounts. We then find the auditor is in a position of knowing that he ahs sufficient evidence to substantiate the detail of the accounts. He then needs to form an opinion as to whether the accounts as a whole contain certain qualities and this is when a final review is carried out. This s a stage of the audit carried out by senior members of the audit team using checklists. The key being the Companies Act checklist and the IAS checklist. This is further to the analytical review procedures carried out as part of substantive tests. The aims of this review are:

(i) To provide audit evidence by determining if the financial statements provide information that is internally consistent with other information in the possession of the auditor and
(ii) Also to determine if the financial statements have been prepared using acceptable accounting policies, they comply with IAS's and other requirements and that there is adequate disclosure of all relevant matters.

The quantities required of the final accounts:
The final accounts possess certain qualities and these are:

(a) Use of acceptable accounting policies, appropriate to the business and consistently applied
(b) They must show the results of operations in the profit and loss account, state of affairs in the balance sheet, changes in the financial position in the cash flow statements and all other information included in the financial statement should be compatible with each other and with the auditor's knowledge of the enterprise.
(c) All appropriate matters should be adequately disclosed and information contained in the accounts should be suitably classified and presented
(d) There must be compliance with statutory requirements
(e) There must be compliance with other relevant regulations
(f) There must be compliance with International Accounting Standards

The final review may reveal

(a) All is well or
(b) Further audit evidence is required in some areas or
(c) That it may be desirable to make amendments o the accounts and
(d) That a qualified report may be required

The review stage is very important in modern auditing as current auditing opinion is moving more towards a consideration of the view given to users by financial statements. The detail is still important but the view given must be true in detail and fair in totality.

ANSWER FOUR
MAL ENGINEERS LIMITED

Masaku & Masaku
Certified Public Accountants
P.O. Box 2411 KNH
Nairobi

The Directors
Mal Engineers Limited
P.O. Box 57985
Nairobi

Dear Sirs

We have commenced planning the audit of the financial statements for the year ending 30 September 20x6. As already mentioned in our letter of engagement dated 1 April 20x6, our audit is designed to give us – in the main- reasonable assurance that the financial statements give a true and fair view as at the balance sheet date. It therefore involves considering the suitability of significant accounting policies by the company.

It is generally held that for an accounting policy to be suitable it must be:

(i) Acceptable i.e. in accordance with generally accepted accounting principles
(ii) Commonly adopted within that particular industry
(iii) Consistently applied over the years within the enterprise
(iv) Consistently applied throughout the enterprise
(v) Appropriate and applicable to the particular circumstances
(vi) In compliance with relevant IAS
(vii) Adequately disclosed in accordance with IAS 1 and the framework for the preparation and presentation of financial statements.

Our initial review of the significant accounting policies has revealed that the accounting policy adopted with regard to service contract income might not be suitable for the following reasons:

(i) One of the fundamental accounting assumptions is that of matching revenues with the cost of generating that revenue. These service contracts are for a three years' period and the company therefore has to commit itself to costs over the period of the contract.

Accounting for income at the date of inception of the contract but charging costs as they are incurred would imply hat the company is not matching revenue with related costs. Contract revenue is so significant to the operations of the company that this policy would seem to be imprudent as profits are likely to be overstated.

(ii) This policy is not commonly adopted within the industry in which you operate.

We recommend that the contract revenue is credited to the profit and loss of account over a three
year period, based on the proportion of the actual cost incurred during each year.

For the financial statements to give a true and fair view we further recommend that the amount of contract revenue taken credit for any one year be separately disclosed as a note to the financial statements, sot that the reader of the accounts can determine:

- The un-credited reserve at the beginning of the year
- Amount credited during the year
- Amount of new contracts entered into the year
- The balance at the end of the year disclosed as unearned income

In addition, the accounting policy note to the financial statements should disclose this accounting policy. In our opinion adoption of this policy will ensure that the accounts present fairly the results from operations and the profits will not be overstated.

Please do not hesitate to contact us for any further clarification you may consider necessary

Yours truly
MASAKU & MASAKU
CERTIFIED PUBLIC ACCOUNTANTS

ANSWER FIVE

(a) The controls that ensure that only authorized purchase invoice and credit notes are posted to the purchases ledger will include;

(i) The establishment of a purchasing committee that considers the material and service needs of the company and through some tendering system identifying the optimum suppliers and after entering into trade agreements with them producing an approved suppliers list.

(ii) Accounts for suppliers would only be opened in the creditors ledger on the basis of the approval list of suppliers

(iii) There should be a stipulation that only the purchasing committee can add or delete names from the list of approved suppliers. This list should be distributed to all the departments that have some dealing with the suppliers such as stores, accountants, administration and particularly the cheque signatories.

(iv) A purchase order should be raised for all purchases. A goods received note should be raised to acknowledge receipt of the materials ordered and checking it for quality and quantity.

(v) The suppliers invoice should be matched against the purchase order and the goods received note. It should be checked for accuracy. The same should apply to credit notes. A goods returned note should be raised and a debit note to the supplier. These should be matched before the credit note is posted. A thoroughly checked invoice and credit note should then be posted to the creditor's ledger card. The work of accounts clerks should be checked and supervised by the chief accountant.

(vi) A budgetary control system should be instituted to ensure that unexpected trends are quickly noted and corrected. Unusual trends will be detected by falling margins etc and investigated.

(vii) An internal audit function should regularly match the records with each to ensure consistency and completeness.

(viii) Creditors statements should e requested and reconciled to the creditors ledger cards.

(ix) Payments should be on the basis of genuine invoices and not statements. A selection criteria should be in place for determining the invoices to be paid

(x) The cheque signatories should ensure that the cheques are payable to suppliers on the approved suppliers list. A cheque requisition should have been raised to authorize the payment of the invoice.

(b) Controls over the addition, amendment and deletion of suppliers from the suppliers list and ensuring that only authorized suppliers are on the standing data file.

(i) There must be in place a competent purchases committee composed of knowledgeable officers from the concerned departments, accounts, stores, buying and production. This committee will identify the material needs of the company well in advance. Then invite quotations from possible suppliers. Identify the optimum suppliers and enter into written contracts or agreements with them. Then produce an approved suppliers list which is distributed to the other department who may have dealings with the suppliers.

(ii) The accounting department should be under clear stipulation that they will only open an account for a supplier in the creditors ledger or remove a suppliers name from the creditors ledger upon written formalized authority of the purchasing committee. A pre-printed, pre-numbered change form should be filled in and signed by both the purchasing committee and the chief accountant.

(iii) Periodically the accounting department should produce a hard copy of all the suppliers who still have open operational accounts and this list should be scrutinized by the purchasing committee and compared with their own list to detect changes not authorized.

(iv) There should be an internal audit function to review the records of the company for consistency

(v) Bank reconciliations should be produced regularly and checked and approved by a senior officer. All long outstanding reconciling items should be investigated.

(vi) Blank unused cheques should be under lock and key. Should be subject to control by a register and released in numerical sequence.

(vii) The blank unused cheques should be checked physically regularly to ensure that they have not been stolen and used out of sequence

(viii) All the supporting evidence should be regularly checked to ensure that it has not been used to support more than one payment. Infact it should be stamped paid once the payment has been made.

(ix) The distribution of the cheques should be closely monitored

(x) Reconciliations of supplies accounts with their statements should be routinely carried out to confirm that payments are being credited by suppliers on the statements

(c) Controls over the cheque payments and custody of the cheques

(i) A senior official should routinely match all automatic payments of up to Kshs.5000 to the underlying supporting documentation even if it is after the cheques are released. This would detect suspicious payments such as cheque splitting where many small cheques are raised for one supplier to defeat the authority levels.

(ii) The numerical sequence of the cheques upto Kshs.5000 should be checked automatically by the computer and any missing numbers reported and investigated immediately. This is to ensure completeness of accounting for all cheques.

(iii) The numerical sequence of all cheques should be checked regularly and exception reports produced by the computer should be reviewed and approved by senior officers.

(iv) The cheque signatories whose signatories are pre-printed on the cheque upto Kshs.5000 should periodically monitor the distribution of those cheques.

(v) Regularly a sample of cheques that have been paid should be obtained from the bank and the details agreed to the documents and regularly checked for any changes to standing data and to confirm that they have been authorized.

(vi) Any changes to the standing data should be automatically logged by the computer system which should 'flag' any such changes and these should be confirmed as authorized changes by the purchasing committee.

(vii) Authority to alter the standing data should be vested in the chairman of the purchasing committee and the chief accountant. The computer should be programmed to only effect changes authorized by these two officials upon keying in their passwords.

DECEMBER 2003

QUESTION ONE

(a) For the assignment to be completed in the specified time restriction the client will take the following steps:
- Ensure that all employees affected by the audit are aware
- The books of account should be up-to-date so that the auditor will not be delayed
- An interim audit should be undertaken to ensure that work that can be done early is done.
- The following key audit tasks will be undertaken during the interim audit.

(b) Steps to be taken by the auditor
- Adherence to deadlines in the audit process
- Use more experience staff
- Perform most of the work during the internal audit
- Group accounting issues should be dealt with early in the process
- Quality assurance procedures should be adhered to.

ANSWER TWO

For many businesses, sales are made on credit and thus the sales cycle includes control objectives for receivables. These controls objectives include:

(a) Customers' orders should be authorized, controlled and recorded in order to execute them promptly and determine any allowance required for losses arising from unfulfilled commitments.

(b) Goods shipped and work completed should be controlled to ensure that invoices are issued and revenue recorded for all sales.

(c) Goods returned and claims by customers should be controlled in order to determine the liability for goods returned and claims received but not entered in the accounting records.

(d) Invoices and credits should be appropriately checked as being accurate and authorized before being entered in the accounting records.

(e) Validated receivables transactions, and only those transactions, hold be accurately entered in the accounting records.

(f) There should be procedures to ensure that sales invoices are subsequently paid and that doubtful amounts are identified in order to determine any allowance required.

In order to achieve these objectives there should be good segregation of duties. There are three distinct processes in the sales system which should be segregated and performed by different staff in order to establish effective internal controls. They are:

(a) *Accepting customers' orders*: Sequence controlled documents should be used to acknowledge all order received. Any uncompleted orders should be regularly reviewed.

Credit limits should be checked by the credit control department. Selling prices, special discounts and delivery dates should be fixed by senior members of the sales department – never by the account staff.

(b) *Dispatch department*: Sequence controlled documents should be used (goods outwards or dispatch notes) for all goods leaving he premises. These should be completed by the gatekeeper or the dispatch department – never by the account staff.

(c) *Invoicing the goods*: Sequence-controlled invoices should be raised by the sales department and then passes to the accounts department for recording. Independent checks should be made to ensure that invoices have been raised for all goods outwards notes.

In addition strict control of credit notes is essential to ensure that they are raised by proper authority in the sales department against goods received notes. It is not uncommon for credit notes to be raised to 'hide' what are in fact bad debts or to conceal theft of cash receipts. Credit notes can also be used to cancel out fictitious sales invoices which have been raised in order to boost sales figures artificially.

There are a large number of controls that may be required in the sales cycle due to the importance of this area in any business and the possible opportunities that exist for diverting sales away from the business and other persons benefiting.

(a) Orders

(i) The orders should be checked against the customer's account; this should be evidenced y initialing. Any new customers should be referred to the credit control department before the order is accepted.

(ii) Existing customers should be allocated a credit limit and it should be ascertained whether this limit is to be exceeded if the new order is accepted. If so the matter should be referred to credit control.

(iii) All orders received should be recorded on pre-numbered sales order documents.

(iv) All orders should be authorized before any goods are dispatched.

(v) The sales order should be used to produce a despatch note for the goods outward department. No goods may be despatched without a dispatch note.

(b) Despatch

(i) Dispatch notes should be pre-numbered and a register kept of them to relate to sales invoices and orders.

(ii) Goods dispatch notes should be authorized as goods leave and checked periodically to ensure they are complete and that all have been invoiced.

(c) Invoicing and credit notes

(i) Sales invoices should be authorized by a responsible official and referenced to the original authorized order and dispatch note.

(ii) All invoices and credit notes should be entered in sales day book records, the accounts receivables ledger, and accounts receivable ledger control account. Batch totals should be maintained for this purpose.

(iii) Sales invoices and credit notes should be checked for prices, casts and calculations by a person other than the one preparing the invoice.

(iv) All invoices and credit notes should be serially pre-numbered and regular sequence checks should be carried out.

(v) Credit notes should be authorised by someone unconnected with dispatch or accounts receivable ledger functions.

(vi) Copies of cancelled invoices should be retained.

(vii) Any invoice cancellations should lead to a cancellation of the appropriate dispatch note.

(viii) Cancelled and free of charge invoices should be signed by a responsible official.

(ix) Each invoice should distinguish between different types of sales and any sales taxes. Any coding of invoices should be periodically checked independently.

(d) Returns

(i) Any goods retuned by the customers should be checked for obvious damage and, when accepted, a document should be raised.

(ii) All goods returned should be used to prepare appropriate credit notes.

(e) Receivables

(i) A receivables ledger control account should be prepared regularly and checked to individual sales ledger balances by an independent official.

(ii) Receivables ledger personnel should be independent of dispatch and cash receipt functions.

(iii) Statements should be sent regularly to customers.

(iv) Formal procedures should exist for following up overdue debts which should be highlighted either by the preparation of an aged list of balances or in the preparation of statements to a customers.

(v) Letters should be sent to customers for collection of overdue debts.

(f) Bad debts

(i) The authority to write off a bad debt should be given in writing and adjustments made to the account receivable ledger.

(ii) The use of court action or the writing-off of a bad debt should be authorized by an official independent of the cash receipt function.

Tests of Control

Tests of control should be designed to check that the control procedures are being applied and that objectives are being achieved. Tests may be appropriate under the following broad headings:

(a) Carry out *sequence test checks* on invoices, credit notes, dispatch notes and orders. Ensure that all items are included and that there are no omissions or duplication.

(b) Check the *authorization* for the

- Acceptance of the order (the credit worthiness check)
- Dispatch of goods
- Raising of the invoice or credit note

- Pricing and discounts
- Write-off debts

Check both that the relevant signature exists and that the control has been applied, e.g. check pricing for accuracy and credit limits to ensure that they have not been exceeded. This last test will also serve as a substantive procedure.

(c) Seek evidence *of checking of the arithmetic accuracy* of
- Invoices
- Credit notes
- Sales tax

This is often done by means of a 'grid stamp' requiring several signatures on the face of the invoice. Ensure that the control has in fact been applied by checking the accuracy of such invoices and credit notes. This last test will also serve as a substantive procedure.

(d) Check *dispatch notes* and gods returned notes to ensure that they are referenced to invoices and credit notes and vice versa.

(e) Check that *control account reconciliation* have been performed and reviewed. Reper form the control by checking the reconciliation to source documentation.

(f) Ensure that *batch total controls have been applied* by seeking signature and tracing batches from input to output.

In all cases, test should be performed on a sample basis. The auditor should investigate errors and consider the need for further testing to obtain comfort on the proper application of the control procedures.

QUESTION THREE

(a)
The proposed takeover will have an impact on the audit approach because management will be under pressure to portray the performance of the company in a better picture in order to raise the takeover price; Earnings management is a significant audit risk in the case of Tex Ltd.

Provisioning is an area where management may try to manipulate in order to increase reported profits. Therefore since the risk of management override of controls is likely, substantive auditing is testing will be key in the audit approach.

For the item sundry accruals and provisions all the figures are materially lower in the current financial period hence the reasons for the changes must be sought and the auditor must be alert for other area where creative accounting may be utilized to boost profits such as capitalization of revenue expenses or failure to recognize asset impairments.

I will also be alert for evidence of fraud since it is apparent that the management is already biased.

(b)
1. Sundry accruals

(i) **Accounting Treatment**

According to IAS 37, accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees accruals are often reported as part of trade and other payables where provisions are reported separately.
According to IAS 1, presentation of financial statements, states that all items of income and expense should be included in the profit or loss account, unless another standard requires otherwise.
Therefore the above accounting treatment for sundry expenses is in accordance with accounting standards.

(ii) The audit work performed on 68 Co. of the total amount is adequate assuming that the auditor is not put upon inquiry.
The decrease (8,382,530 – 6,290,010 = 209,520) is below the set materiality level.
However, materially is not only quantitative, it is also qualitative and based on this, additional work may be necessary since the audit risk is significant for these client.

(iii) **Additional Work**
- A sample of the amounts below Shs. 100,000 should be taken and evaluated in details.
- Cut off procedures for the expenses should also be evaluated and the documentation for the accruals immediately before and after the balance sheet date verified.

2. Provisions for leave allowances
Leave allowances are employee benefits and should be accounted for in accordance with IAS 19, Employee Benefits.

Leave allowance is a short term employment benefit and according to IAS 19, should be expensed in the period in which it is incurred, that is, the employees render the service that entitles them to the leave allowance.

Leave allowances are either accumulating or non accumulating.

In the case of accumulating compensated absences, the entity should recognize the expected cost when the employee renders the service that increases their entitlement to future compensated absences. In the case of non-accumulating, when the leave allowance is taken.

The decrease in the provision (10,302,710 to 3,002,850 = 7,299,860) is almost three times the materiality level hence significant.

This decrease represents benefits that had vested in employees employees and therefore should not be accounted for as income. The charge for current period in accordance with the revised policy is correct but the auditor should find out how the balance has been accounted for major maintenance.

(i) **Accounting Treatment**
Provision for major maintenance should not be recognized and the whole amount should be written back to the profit and loss account. I disagree with the accounting treatment.

(ii) **Audit Work**
The audit work done is not adequate due to the impact of the decrease on reported profits and its implications on the integrity of management as well as the reliability of management presentations.

(iii) **Additional Audit Work**

- Enquire of management the reasons of the change in policy and whether the affected workers are informed of the changes.
- Verify the workings for the provisions and check for compliance with IAS 19 and IAS 37.
- Analyze the suitability of the provision , the terms and the conditions of workers.

A provision is defined by IAS 37 as a liability of uncertain timing and amount and should only be recognized when the entity has a present obligation (legal or constructive) as a result of a past event, is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made by the amount of the obligation.

As far as maintenance is concerned, there is no obligating event (a past event that leads to a present obligation) since for an event to be obligating, the entity must have no realistic alternative to settling the obligation. Financial statements deal with the financial position at the end of its reporting period and not its possible position in future hence no provision should be recognized for future operating costs.

Therefore the accounting treatment for the provision for maintenance is not in accordance with IAS 37.

(ii) **Audit Work**

The supporting documents of 21% of the total amount of maintenance provision seen is not adequate audit work. The period and reasons as to why the large provision was created needs to be verified.

Audit work should be geared towards the objective of the provision, was it ignorance of accounting requirements or was it attempted fraudulent financial reporting.

(iii) **Additional Work**

- Enquire from management why the provisions were created and whether they were aware that it is against accounting standards.
- Verify previous period maintenance costs and whether they are reasonable compared with the current period.

QUESTION FOUR

(a) (1)

Methods that would have been used to overstate the profits.

The methods used to overstate profits for the year ended 31 October 2003 can be categorized into:

(i) Exploiting loop holes in the applicable financial reporting framework.

(ii) Fraud or intentional misrepresentation:-

Examples of these methods include:-

(i) Unsuitable revenue recognition procedures in contravention of IAS 18, Revenue.

(ii) Manipulation of management estimates such as required by IAS 36, impairment of assets, which requires recognition of assets impairments as expenses.

The process of preparing, financial statements requires management statements requires management judgements with regard to the carrying amounts of assets.

(iii) Generous reserve accounting or big-bath provisioning in previous periods which are reversed in the accounting period.

(iv) Failure to recognize appropriate provisions in accordance with IAS 37, this would result in reduced costs.

(v) Improper application of accounting policies with regard to valuation of inventories as per IAS 2, inventories. The management may fail to recognize stock write downs. This affects the closing stock figure hence increasing profits.

(vi) Changes in accounting estimates intended to lower charges for depreciation.
(vii) Recognition of fictitious sales in order to boost profitability.
(viii) Capitalization of revenue expenditures.
(ix) Off balance sheet financing through unconsolidated subsidiaries.
(x) Transactions with related parties with no economic substance or merit.

(b)**(i) Unsuitable revenue recognition procedures**

- Inquire managements policy with regard to revenue recognition.
- Evaluate the internal control on revenue recognition and sales.
- Test cut off procedures to ensure sales are recognized in the correct period.

(ii) Manipulation of management estimates

- Evaluate or update the knowledge of the entity and integrity of management.
- Verify the values of property, plant and equipment with respect to the assertions of cost and valuation.
- Apply procedures prescribed by ISA 545, Fair Value Measurements.

(iii) Generous reserve accounting in prior periods.

- Enquire whether the firm has adhered to provisions of IAS 37, and whether it did so in previous periods.
- Compare current years financial statements with previous period to ascertain whether any previous created provisions have been released during the current accounting period.

(iv) Failure to make requisite provisions in the current period.

- Obtain an understanding of the operations of the company in the current period and ascertain that no new provisions were required or no increase in provisions was required in the current accounting period.

(v) Improper accounting for inventories

Inventory has a very significant impact on reported profits and can be easily manipulated. High closing stocks result in high profits hence management may not provide for write downs on slow moving, damaged, or obsolete items.

- Inquire, evaluate and recommend, appropriate, changes to stock taking instructions since this is an area of audit risk in the current period.
- Carry out analytical review using stock turnover ratios as well as the absolute figures, and compare this with the previous periods.

(vi) Changes in accounting estimates with regard to depreciation

- Carry out verification for property, plant and equipment with respect to the assertions of cost and valuation.
- Review policy on depreciation and ensure that it complies with ISA 16.
- Compare current year figures with the previous years figures.

(vii) Recognition of fictitious sales

- Carry out substantive tests on sales and vouch end of period sales to ensure that the books of account support the sales figures.
- Carry analytical review on the sales and cost of sales figures as well as stocks to ensure that there is a reasonable relationship.

(viii) Capitalization of revenue and expenditures

- Evaluate the movements on property, plant and equipment schedules and vouch any changes.
- Compare the current periods income statement expense headings with the previous period and seek details on major changes.

(ix) Off balance sheet financing in unconsolidated subsidiaries.

- Enquire from management of the existence of subsidiaries.
- Review the sources of finance and changes in the working capital.
- Review the cash flow statement.

(x) Transactions with related parties

- Carry out procedures to identify related parties.
- Review the transactions with related parties to ensure that they were firms and had economic substance or otherwise.

QUESTION FIVE

(a) My attitude and action to take will be influenced by several considerations as follows;

- Objectives of the audit engagement and implications of the fraud and illegal activity on the auditors report.
- The materiality and extend of the misappropriation.
- The questionable integrity of the managing director.
- The managing directors understanding of the implications of the illegal acts on company as well as personal implications.
- The implications for the audit firm with regard to professional negligence with respect to the company.
- The reputational risk the audit firm faces for associating with clients like Craig Ltd.
- Professional authoritative guidelines governing fraud and illegal activities mainly ISA 240, Auditors responsibility to consider fraud in an audit of financial statements and ISA 250, consideration of laws and regulations in the audit of financial statements.
- The specific provisions of the Value Added Tax (VAT) Act with reference to penalties, fines and the implications for the auditor for Craig Ltd and the managing director.
- Professional obligations, criminal and civil law with regard to illegal acts by clients.

The actions I would take will be dictated by professional guidance, legislation and legal advice from my lawyer.

- On discovery of the above, I would conduct further audit procedures altering the nature, extend and timing of the procedures to ensure that other material misstatements due to fraud or error exist.
- Evaluation the impact of the misstatement due to fraud at the assertion level and financial statements as a whole for materiality and its implications for the audit report.
- For the non compliance with the value added tax law, I will consider the potential financial consequences, such as fines, penalties, damages, disclosure requirements, the seriousness of the non compliance so as to call into question the time and fair view given by the financial statements.
- I would seek permission from Mr. Craig to discuss with his lawyer the implications.
- I would also consult with my own lawyer to discuss the possible legal consequences and the action I should take.
- Consider withdrawing from the engagement.

(b) If my firm was doing the audit for the first time, I would consider the reputational risk posed by associating with Mr. Craig to our firm and seek legal advice.
I would discuss with the risk partner in our firm and withdraw from the audit if Mr. Craig has not undertaken corrective action.
If Mr. Craig does not adjust the financial statements and underlying records, I will withdraw from the engagement, seek legal advise.

(c) If Mr. Craig demands for my immediate resignation, I would discuss the issues with him, explain to him the implications of the fraud and illegality of his actions to the company and himself.
If no amicable understanding is achieved, I would seek legal advice and consider my professional and legal obligations having been the audit of Craig Ltd.

JUNE 2004

QUESTION ONE

Managing Director,
Tropical Garments Ltd.,
P.O. Box 2411 K.N.H., 00202
Nairobi.

Dear Sir,

Re: RECOMMENDATIONS FOR A SUITABLE SYSTEMOVE THE PAYMENT OF WEEKLY WAGES

Following your request for a new payroll system internal control, we have the pleasure of submitting our recommendations:

We have taken into consideration the control already set and the financial position of the company to ensure that our recommendations are simple, efficient and effective in their implementation.

The recommendations cover the following areas:

(i) The hire and dismissal of employees

(ii) The recording of attendance and job time by use of the clock card and time sheets

(iii) The reparation of the payroll including checking the hours worked, calculation of gross pay and net pay.

(iv) Authorization and approval of the payroll

(v) Signing of the pay check

(vi) Distribution of the money during the payout parade

(vii) Dealing with unclaimed wages

(viii) Dealing with dummy employees

The above components of the internal control system will ensure that the payments of weekly wages objectives are achieved.

Specific Control Procedures include:

- There should be written authorization to employ or dismiss any employee, in accordance with company procedures and legal requirements.

- Changes in rates of pay or salary should be authorized in writing by an official outside the wages department. This may be through a standard form for authorization of changes to payroll details.

- Overtime worked should be authorized by the works manager or employee's manager or someone outside of payroll and be in accordance with company procedures. Some staff

may not be entitled to overtime because of their level or type of employment and therefore appropriate mechanisms for ensuring only authorized staff receive overtime.

- An independent official should check the payroll and sign it.

- The wages cheque should be signed by two signatories evidenced against the signed payroll. Cheques should have two signatories and should be checked against an approved payroll entry.

- Where pay relates to hours at work, some form of time recording should be used for example; time keys, automatic entry swipe card systems or other clock cards should be used. There should be supervision of the time recording systems or cards and the timing devices, particularly when employees are clocking on or off. There is a clear risk that staff can manipulate systems to obtain additional hours and therefore additional payments. This could include getting other staff to clock in or out for them. The manager or supervisor should know the hours worked by staff and check outputs to ensure that expected and actual hours tally.

- When employees have been absent for a significant period their entitlement to salary should be checked against personnel details.

- Personnel records should be kept for each employee giving details of engagement, retirement, dismissal or resignation, rates of pay, holidays etc., with a specimen signature of the employee.

- A wages supervisor should be appointed who could perform some of the authorization duties listed above.

Prompt recording and arithmetical accuracy

- Payroll should be prepared from clock cards, job cards etc., and a sample checked for accuracy against current rates of pay.

- Payroll details should provide for the accurate calculation of deductions such as tax, social insurance, pensions and other approved deductions, which should be checked periodically.

Access to assets and records

- Employees should sign for their wages

- No employees should be allowed to take the wages of another employee

- When wages are claimed late, the employee should sign for the wage packet and the release of the packet should be authorized.

- The system should preferably allow the wages to be checked by the employee before the packet is opened, by using specially designed wages packets.

- The duties of the wages staff should preferably be rotated during the year, and ensure that no employee is responsible for all the functions in respect of any particular department.

- The employee making up the pay packets should not be the employee who prepares the payroll.

- A surprise attendance at the pay-out should be made periodically by an independent official.

- Unclaimed wages should be recorded in a register and held by someone outside the wages department until claimed or until a predefined period after which he money should be re-banked. An official should investigate the reason or unclaimed wages as soon as possible.

Control accounts

- Control accounts should be maintained in respect of each of the deductions showing amounts paid periodically to the tax authorities etc.

- Overall checks should be carried out to highlight major discrepancies e.g. check against budgets, changes in amounts paid over a period of time, check against personnel records.

- Management should exercise overall control.

- The above categorization is based on the list of types of controls included in ISA 400 Risk Assessment and Internal Control. The following parts of this section illustrate controls expected in other major areas. These are not classified by type.

Tutorial Note:

Try generating a couple of these areas yourself then review the controls suggested. There is no necessity to learn these lists but you should practice the technique to generate them, and use the rest of the section for reference.

Control procedures – Salaries

- Personnel records should be kept similar to those for hourly paid employees.

- Written authority should be required to employ or dismiss an employee or change salary rate.

- Overtime should be authorized by someone outside the payroll department.

- The usual checks on deductions are required.

- When employees have been absent for a significant period their entitlement to salary should be checked against personnel details.

- Cheques should have two signatories and should be checked against an approved payroll entry.

We look forward to discussing the above controls to evaluate the feasibility of the above recommended controls. Thank you.

Kamau and Company
Certified Public Accountants

QUESTION TWO

Potential Risk	Audit Procedures
1. Financial reporting risk	1. Review the transactions between MPH and RS
2. Foreign operations risk	2. Review currency exchange rates.
3. Exchange risk	3.Reviewthe translation exercise
4. Related party transactions resulting in misrepresentation	4. Request for a letter of representation showing details and disclosures are appropriate
5. Pension fund not being able to pay benefits	5. Review the basis on which the surplus was determined. Consult actuaries
6. Inadequate provisions to boost profits	Review cut off procedures for sales and purchases

QUESTION THREE

Tutorial Note: This question deals with the audit of stocks

(i) Audit procedures to verify the accuracy of the inventory count.
(ii) Before the inventory count.
(iii) On the day of the inventory count.

(b)
(i) Request for the schedule and check its arithmetical accuracy
(ii) Take a sample of the stock sheets and evaluate the accuracy
(iii) Select a random sample of the goods received on the same day
(iv) Evaluate the reasonable of the overhead allocation and the basis
(v) Request a schedule for production labour and their work areas to ensure that non production labour is not include
(vi) Request a letter of representation

(c) **Purchases cut off procedures**
The procedures applied by the auditor will be designated to ascertain whether:
(i) Goods received for which no invoice has been received or accrued;
(ii) Goods received which have been invoiced but not yet posted are accrued; and
(iii) Goods returned to suppliers prior to the year end are excluded from stock and trade creditors.

At the year end stock take the auditor will have made a note of the last serial numbers of goods received notes. Suggested substantive procedures are as follows:
(a) Check from goods received notes with serial numbers before the year end to ensure that invoices are either
(i) Posted to purchase ledger prior to the year end; or
(ii) Included on the schedule of accruals

(b) Review the schedule of accruals to ensure that goods received after the year end are not accrued
(c) Check from goods returned notes prior to year end to ensure that credit notes have been posted to the purchase ledger prior to the year end or accrued
(d) Review large invoices and credit notes included after the yearend to ensure that they refer to the following year
(e) Reconcile daily batch invoice totals, around year end to purchase ledger control ensuring batches are posted in the correct year.
(f) Review the control account around the year end for any unusual items.

Evidence of completeness, existence and ownership – credit circularization
We have established that the verification of trade debtors by direct communication is virtually a standard procedure. Is it therefore also standard procedure to carry out a creditor circularization? The answer is qualified 'No'. The principal reason for this lies in the nature of the purchase cycle – third party evidence in the form of suppliers' invoices and even more significantly suppliers' statements are part of the standard documentation of the cycle. He auditor will hence concentrate on these documents when designing and conducting his test to gain assurance in respect of objective – Do trade creditors represent bonafide amounts due to the company.

In the following circumstances the auditor may, however, determine that a circularization is necessary

(i) Where suppliers statements are, for whatever reason, unavailable or incomplete.
(ii) Where weaknesses in internal control or the nature of the client's business make possible a material misstatement of liabilities that would not otherwise be picked up
(iii) Where it is thought that the client is deliberately trying to understate creditors
(iv) Where the accountants appear to be irregular or if the nature or size of balance transactions is abnormal.

In these cases confirmation requests should be sent out and processed in a similar way to the debtors' confirmation requests described above. 'Positive' requests will be the order of the day in these circumstances.

In normal circumstances the following substantive procedures based on accounting records and documentation maintained and retained by the company will be performed:

(i) Select from the trade creditors listing and check to supporting documentation (invoices, goods received notes, purchase orders, etc.)that the purchase was for the purpose of the business.
(ii) Reconcile a sample of purchase ledger balances with suppliers' statements
(iii) Review balances for unusually low balances with major suppliers
(iv) Compare ratio of trade creditors to purchases with previous year's figures.
(v) Compare ratio of trade creditors to stock with previous year's figures.
(vi) Verify reasonableness of deductions from liability figures (e.g. discounts) by reference to subsequent events.
(vii) Ascertain reasons for significant debit balances.

QUESTION FOUR

(a) According to ISA 240 the auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.

Auditors are required to assess the risk of fraud and error causing financial statements to contain material misstatements and should enquire of management as to any fraud or error that has been discovered. Based on this assessment which will involve consideration of the integrity on the entity, unusual pressures on the entity, unusual transactions and problems in obtaining sufficient appropriate audit evidence.

Management is responsible for the prevention and detection of fraud and error though the implementation and operation of adequate accounting and internal control; systems will reduce the possibility of fraud and error.
This responsibility has been reinforced in recent years especially for listed companies by the promotion of codes of corporate governance.

(ii) The audit firm is not negligent of the fraud amounted to Shs.400,000.

This represents x% of sales and x% of profit before tax.

(iii) If the fraud amounts to Shs.1,600,000,then the firm is negligent because tis represents x% of sales and x% of profit before tax.

(b) (i) The amount of Shs.8,000,000 is a material item in the financial statements.

$$\frac{8{,}000{,}000}{640{,}000{,}000} \times 100 \qquad \frac{8}{640} = \frac{1}{8}$$

(ii) Matters to consider and action to be taken.

- Materiality of the amounts
- The overall opinion on the financial statements

If I am replaced as the auditor I will seek legal advice and advise the client to streamline the operations and do everything correctly.
Since the Managing Director is the majority shareholder this will prevail

(iii) This scenario is much better than the previous one.
Matters to be considered

- Materiality of the work
- Write or go through the cards

(iv) I would report and explain the fraud to the audit committee since the Managing Director is a minority shareholder, the other directors will impress upon him that the fraud should be reported.

The Managing Director is likely to agree to amendments of the accounts because adverse publicity is very serious for a listed company.

I would seek legal advice.

ANSWER FIVE

(a) Circumstances in which n auditor would report without qualification for a small company

(i) Adequate internal controls exist
(ii) The owner/manager is involved in the management and his presence compensates for weaknesses in controls
(iii) If during the performance of audit procedures there is adequate evidence to show that books of accounts are well kept and everything is in place.
(iv) If any misstatements are considered immaterial
(v) The integrity and cooperation of management excellently
(vi) Sufficient appropriate audit evidence is available

(b)

(i) Breach of the fiduciary position held by the receiver manager
(ii) Entering into contracts which are not accepted by the courts
(iii) Failure to exercise reasonable care and skill expected in that position

(c)

(i) Ensure that all contracts are within legal framework
(ii) Ensure that he exercises reasonable care and skill
(iii) Seek legal advice as appropriate.

DECEMBER 2004

QUESTION ONE

(a) The general access controls will include both physical controls and programmed access controls.

- The computers should be kept in rooms with restricted access. Only authorised personnel should have access.
- When the computers are unattended relevant programs should not be left running.

- That the terminals will be . linked to the mainframe computer through a dial up link means that the machines communicate through a telephone line. This means that there is a danger that communication between the computers could be interpreted and transmission intercepted without proper authority. Therefore I would expect that built into the system would be the provision of a dedicated line at Mwebeni Ltd. such that when the mainframe computer receives a signal from a terminal it will not accept instructions directly rather it would call back at the dedicated number at. to facilitate the dial up link.

- All authorized users should have been issued with passwords or some other form as identification such that once the dial up link has been facilitated the system should demand for a password which must be keyed in. In this way different levels of access can be given to the staff e.g. the purchases ledger clerk can access the system for reading purposes only without the authority to effect any transfers.

- The password has to be keyed in for the computer to determine the degree of access the password holder is permitted.

- The system should have been programmed that transfers can only be effected at certain times like between 11 a.m. and 3 p.m. on a working day. When any attempt is made to effect transfer the system checks against its in built clock and confirm that time access is being attempted is reasonable.

- A comprehensive creditors master file should have been built up with all details of the creditors bank and the account number at that bank. These details would have to be keyed in when a transfer is to be made. The creditor's master file must be on line when transfers are being effected so that the sytem automatically performs a master file check to ensure that the company does have such a supplier. At the same time the programme would also perform a reasonableness check that the proposed amounts to be transferred do not exceed the amount due to that supplier.

- Both ends of the system should have been programmed to automatically prepare a record of the transfers that have been effected.

- A limit should have been built into the ystem such that only transfers below this amount should be effected by line system, any amounts in excess should be rejected requiring a cheque signed by the authorized signatories.

- A requirement should have been in place that passwords should be changed regularly. There should have been built into the sytem to deny access or refuse to act on the instructions of password users who has not changed their password within the stipulated time.

- Should have built into the system a ,mechanism for the system to close down automatically if a wrong password is entered more than 3 times.

- Similarly it should close down it require the password to be keyed in again if no activity takes place when the 2 machines are linked for a period of time, say 5 minutes.

- Should have built into the system a mechanism that informs the mainframe computer the number of transfers to be effected so that once many transfers have been effected the dial up link is immediately disconnected.

(b) The additional measures that Mwebeni. should take in order to prevent unauthorized transfers:

(1) Ideally the terminals should be located in a secure office to which access is restricted to only authorized personnel at approved times. This is the normal lock and key.

(2) The microcomputer that facilitates the dial up link could be required for other work therefore it may not be practicable to only use it to effect transfers.

(3) There should be restrictions on opening new accounts for suppliers or removing names of suppliers from the creditors master files or even changing the supplier details. There should be pre printed, prenumbered change forms when a new suppliers has been approved by the purchasing committee and their details entered in these forms whould be approved by both the chief accountant and purchase committee.

(4) There should be arrangements for the creditors master file to be regularly dumbed and normally checked.

(5) Before any transfers are affected the invoices to be paid should be subjected to a payment selection criteria. They should have been supporting documents attached to them. A list should be prepared and it should have the written authority for the transfers to be effected in the form of a signature by the cheque signatories and this list should be retained.

(6) Once the transfers have been effected the supporting documents should be stapled and cross referenced to the transfer number.

(7) At almost all the times of the month only the minimum balance should be retained on this bank account. When the list if transfers to be effected has been approved the money can then be transferred from the main account to this account for the transfers to be made.

(8) Regular bank reconciliations should be prepared, reviewed by responsible officials and approved. Any long outstanding items should be investigated.

(9) Reconciliations of creditors statements should be regularly prepared, the long outstanding reconciling items being investigated.

c) Controls to be implemented at eh accounts payable and payroll systems over:

i) Retrieval of information:

- Access controls should be implemented by use of pass passwords
- The relevant software should not be installed in all terminal to ensure that there is no possibility of unauthorized access
- A list of all retrievals and by who should be maintained.

ii) Input of transaction data.

These controls aim at ensuring the completeness of input and it validity. Most errors in computerized accounting systems can be traced to faulty input. controls over the completeness and validity of all input are therefore essential. The controls over input will include:

- Data conversion
- Controls over rejections which should be investigated
- Correction and processing of rejections
- Batch controls and computer edit controls.

The most common input controls include:

- Missing field checks
- Validity character check
- Reasonableness checks
- Missing file checks
- Check digits
- Document counts

QUESTION TWO

a) Changes to be made at the interim audit:

(i) The timetable for the audit will be considered for it applicability in view of the fact that more substantive procedures will be undertaken.Significant dates in the timetable include, the date of the AGM, the date when the directors sign the financial stsatements,the period of the final audit, stock take dates

(ii) A visit will be made to the company prior to any detailed work to meet the directors to make them aware of the fact that the controls are not operating effectively . I will show them the revised timetable to ensure that they understand the need for the changes nad schedule the role of the clients staff in areas such as bank reconciliations, suppliers statements, doubtful debt schedules and fixed asset movements.

(iii) Ascertain early in the process key changes in accounting personnel

(iv) Resolve previous years problems

(v) The introduction of any new standards will be considered.

(vi) I will assess the level of experience required in this audit which can be described as being risky.

(vii) Specify the materiality levels at slightly lower levels compared with the preliminary materiality levels in view of the ineffective controls.

(viii) Prepare a detailed audit planning memorandum including moist of the issues mentioned above.

(ix) Discuss the above issues with the partner responsible for the audit.

b) Changes to the audit plan at the final audit

a. During the final audit the impact of the ineffective controls will be mainly to emphasize on substantive procedures, increase samples and lower materiality levels.
b. I will attend the stock take since this is likely to a material figure in the accounts and is likely to be affected by the weak controls. Issues to be taken care of include existence, ownership and valuation.
c. The audit procedures and the results will be recorded in sufficient details to ensure that all work done, matters considered, and the conclusions reached have been recorded.
d. Similarly to what happens during the interim audit level of quality control will, be very strict.
e. Work will be allocated to staff according to their abilities and all work will be reviewed by senior staff.
f. For the partners review, I will prepare a detailed memorandum which will include:
g. A summary of the financial statements and rations
h. Summary of work done including material items in the financial statements and in areas of high audit risk.

i. A list of all significance errors and suspected fraud
j. List of matters to be discussed with company directors and suggested adjustments.

QUESTION THREE

a) International Accounting Standard (IAS) 1, "Presentation of Financial Statements" paragraphs 23 and 24 state: "When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reasons why the enterprise is not considered to be a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISA's, the phrase "significant uncertainties" is used in similar circumstances.
The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may be set out in accounting standards, legislation or regulation.

b) In planning the audit, the auditor should consider whether there are events or conditions which may cast significant doubt on the entity's ability to continue as a going concern.
The auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessments of the components of audit risk.

The auditor should evaluate management's assessment of the entity's ability to continue as a going concern.

The auditor should consider the same period as that used by management in making its assessment under the financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

The auditor should inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.

When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:
(a) Review management's plans for future actions based on its going concern assessment;
(b) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and
(c) Seek written representations from management regarding its plans for future action.

Procedures that are relevant in this regard may include the following:
- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Considering the entity's plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:

(a) The reliability of the entity's system for generating such information; and
(b) Whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor compares:
(a) The prospective financial information for recent prior periods with historical results; and
(b) The prospective financial information for the current period with results achieved to date.

c) Examples of events or conditions, which individually or collectively, may cast significant doubt about the going concern assumption, are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty3 exists.

Financial
- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.

- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.

Other
- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

d) The current requirements are mainly passive and the interests of all stakeholders would be better served by making the auditor proactive in dealing with going concern issues.
The auditor should be required to participate actively.
The procedures should be dictated by statute so that the auditor will have no alternative but to deal with the issue.

QUESTION FOUR

(a) The main objectives usually associated with audit committees include;

i. Increasing public confidence in the creditability and objectivity of published financial information including unaudited interim statements
ii. Assisting directors (particularly non executive directors) in meeting their responsibilities in respect of financial reporting
iii. Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

b It is recommended that companies should have a committee of the board called the audit committee. This would consist of at least three non-executive directors with written terms of reference which Cleary deal with its authority and duties.

c. An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards
- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditors examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc

- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

(b) The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

(c) It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non-executive members of the audit committee can be suitably independent may be difficult to achieve.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

c) The ban on advertising accountancy services in Kenya is not sustainable.

Developments in the developed countries have led to accountants advertising their services in several countries.
The arguments for advertising include:

- Increasing awareness of the services provided by accountants hence increasing business
- Eliminating the quacks or those who are not licensed because the public will know who is licensed and who is not.
- Giving clients a wide choice
- Enhancing competition hence leading to provision of higher quality services at lower costs and making the services of accountant more affordable to small enterprises.

However it has been argued that advertising will lead to unfair competition and unethical adverts claiming superiority over others. This would dent the image of the profession.

However these events have not occurred in these countries which advertise and therefore since the movement globally is towards advertising it probably a matter of time before advertising is allowed in Kenya.
Failure to make it legal will only promote unethical non standardized process which will actually damage the reputation of the profession.

c) Specific Actions which firms can take to minimize audit risk

- Incorporation into limited liability companies where the laws allow
- Introducing disclaimers in their audit reports and limiting the circulation
- Taking professional indemnity insurance
- Adherring to professional guidelines strictly.

QUESTION FIVE
REGULATION AND PROFESSIONALISM

Kenya answer tips

Part (a) is largely factual and tests your knowledge of the current regulatory framework as it applies to fur aspects of auditing. Revise your knowledge on these fundamental areas if necessary – they are al fundamental to your study of auditing.

Part (b) asks you to discuss. Your ideas and views are being looked for here. This type of question shows the importance of students being aware of the debating points affecting the profession – jot down some ideas on this, (what have you covered on your course? What have you seen in the media? What is discussed in your office?) before attempting your answer. Note that his part of the question carries only 8 marks.

The purpose of this question is to examine students on current and potential changes in practice within the profession.

(a)

(i) Auditing standards are set by the IAASB. ICPAK adopts all of the auditing standards promulgated by the IAASB. Failure by auditors to comply with auditing standards lends them open to disciplinary action by their own accountancy body.

The Companies Act 1989 requires the Recognized Supervisory Bodies (such as the Association of Chartered Certified Accountants) to have rules and practices as to the technical standards t be applied in company audit work and as to the manner in which these standards are to be applied in practice.

Each Recognized Supervisory Body adopts auditing standards in order to meet the Companies Act requirement, and each body is required to have arrangements in place for the effective monitoring and enforcement of compliance with those standards. Failure to apply relevant auditing standards is a factor which an RSB will take into account when deciding whether persons are fit and proper to be eligible for appointment as company auditor.

(ii) Currently the responsibility within a company for the prevention and detection of fraud rests with management. As part of their business responsibilities, the directors of a company have a fiduciary duty to safeguard he assets.

The Cadbury Committee has recently recommended that the auditor should check that the board of a company has established a system which ensures compliance with legal requirements. The auditor is not responsible for preventing fraud but audit procedures should be designed to give the auditor a reasonable expectation of detecting any material misstatements, whether intentional or unintentional in a company's financial statements. This responsibility is set out in SAS 110 Fraud and error (January 1995).

(iii) The auditor should always strive to be objective in his professional judgment. He should not only be independent in fact but he must be clearly seen to be independent in practice. The RSDs has no objective in principle to a practice providing services to a client, additional to the audit.

Care must be taken not to perform management functions or make management decisions. The auditor should not assist in the preparation of financial statements for public company clients unless the work is of a routine clerical nature or in emergency situation. Any fee paid to the auditor for non-audit work should be shown in the financial statements in addition to amounts paid for audit work.

Under the provisions of the Companies Act 1962, an auditor may not be an officer or employee of a client company. Thus it is necessary for the auditor to ensure that he does not make executive decisions.

For example if he recruits key financial and administrative staff, it could be construed as the performance of a management function. The auditor's objectivity may be threatened in such situation and he should be careful that he is not seen as acting as anything other than an independent adviser.

(iv) Under the Companies Act 1985 (s385),a company shall at each general meeting of the company at which accounts are laid, appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next general meeting at which accounts are laid.

The ethical guidance issued ICPAK does not specifically deal with the length of audit appointments. However, the auditor should always be aware of any potential threat to his independence which may because by an audit appointment which has lasted for a disproportionate length of time.

(b)

(i) Auditing standards are set by the Auditing Practices Board whose members are mainly drawn from the members of the auditing profession. The disciplinary procedures applied against an auditor for non-compliance with an auditing standard are enforced by the professional bodies of accountants. Thus politicians have criticized this self regulatory procedure believing it to be open to abuse and lacking independence.

The argument put forward is that the consequences of auditing affect society and therefore in order to ensure that audits achieve social goals, auditing standards should be set by an independent body.

(ii) It is quite apparent from the press and audit research that the public believe that the auditor should and in fact does search for fraud during the conduct of an audit. In view of the recent scandals, particularly BCCI and the Maxwell affair, the public expectation of the extent of an audit has increased.

It is not surprising, given the nature of these scandals that the public finds it difficult to accept that an auditor has no responsibility for the detection and reporting of fraud, especially when one sees the high social cost of these scandals.

(iii) Audit firms do not act exclusively in the capacity of auditors for their clients. Audit work is in some cases, not the main business of audit firms. Auditors provide many other services to their clients including tax advice, brand name valuation and recruitment advice.

Audit firms are dependent upon the fees earned from non audit services, and this dependency can affect the auditors' attitude to the audit. If an audit firm loses the audit, the financial loss to the auditors can be significantly more than just the audit fee he provides other services to the client. Thus a significant amount of pressure can be exerted upon the auditor if he supplies other services to the client.

A significant amount of an auditor's fee income derives from non audit work and in an environment where the audit work is declining; fees for other services are becoming increasingly important.

(iv) It has been argued that the long term nature of the company audit engagement can lead to a loss in auditor independence due to an increasingly familiarity with the company's management.

In many Europe countries, the audit appointment has, by law, to be terminated after a fixed number of years. If the audit appointment was for a fixed minimum period, then auditors would not be under the same pressure to maintain their client base if they know that their relationship with the company was for a limited period, and that audit appointments would be rotated.

JUNE 2005

QUESTION ONE

The Managing Director
Motor Fit Ltd
P O Box 2411
00202 NAIROBI

7 June 2005

Dear Sir

Suggested steps to be taken to reduce time spent on audit work for current year ending 30 September 2005

I refer to your letter dated 7 May 2005 raising issues regarding the costs of the audit.

We have carried out a review of the major factors or determinants of costs of the audit and since our billings are based on the time spent on the audit, we may be able to reduce audit costs.

i) The role of an auditor is to express an opinion on the financial statements. It is the responsibility of management to prepare financial statements in accordance with the identified financial reporting framework.

   We have been preparing the financial statements for your company.

   We suggest that the company prepares the financial statements in accordance with the IFRS so that we shall not need to spend any more time on them.

   We review our letter of engagement.

ii) The late invoices from creditors led to adjustments in the management accounts.
   This led to additional verification work. Earlier communication with creditors will receive the need for additional verification.

iii) Delays in preparation of the final management accounts necessitated the addition of an extra member of staff to meet the deadline imposed on us by the company.

   We suggest timely completion of the management accounts. This can be achieved by increasing the number of members of staff of the accounts department.

iv) The company has increased in size and a number of the locations are separate subsidiaries. We suggest that the audit work at the subsidiaries can be done by other competent firms in those areas. We shall definitely evaluate our reliance on their work.

v) The implementation of the computer system necessitated additional audit work.

   We suggest that the company employs competent personnel to continuously monitor the performance of the system and perform compliance tests. We also suggest the setting up of an internal audit department.

   If our evaluation revels that we can rely on the work of the internal auditor, then the nature, extent and timing of our procedures will be reduced, leading to lowering of audit time.

vi) Stock control problems led to extensive substantive tests. In view of the fact that no serious problems were revealed, other factors remaining constant, then less substantive work will be undertaken in this area. The controls should be strictly adhered to.

We look forward to your co-operation. Let us know your response to the above suggestions.

Yours faithfully

Maungu & Co
Certified Public Accountants

QUESTION TWO

(a) Definition of assurance engagement and its purpose.

The International framework for assurance engagements defines assurance engagement as an engagement in which a practitioner expressed a conclusion designed to enhance the confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to that matter.

According to the framework, an assurance engagement has the following elements;

i) A three party relationship involving a practitioner, a responsible party and intended users.
ii) An appropriate subject matter
iii) Suitable criteria
iv) Sufficient appropriate evidence and
v) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.
(4 marks)

(b) Engagement risk that faces a practitioner who accepts an assurance engagement. According to the framework on AE, an assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.
(4 marks)

(c) Forms of reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk.

The forms of reports given for assurance engagements include reasonable assurance reports and limited assurance reports conveying different levels of assurance in the opinion of the auditor on the subject matter.

In these reports, the responsibilities of the parties should be clearly delineated and the auditor may consider a disclaimer with respect to the inappropriate use of the reports.

(d) Potential to the independence of a firm involved in assurance engagements.

Independence requires independence of mind and independence in appearance according to the IFACs code of ethics for professional accountants.

Independence is threatened by self-interest, self-review, advocacy, familiarity and intimidation threats.

i) Self-interest threat occurs when a firm or member of assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client

Example;
- A direct financial interest or material indirect financial interest in an assurance client
- A loan or guarantee from an assurance client or any of its directors and officers.

ii) Self review threat occurs when any product or judgement of previous AE, or NAE needs to be re-evaluated in reading conclusions on the assurance engagements or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct or significant influence over the subject matter of the assurance engagement.

iii) Advocacy threat – occurs when a firm or member of the assurance team, promotes or may be perceived to promote an assurance clients position or opinion to the point that objectivity may or may not be perceived to be compromised.

iv) Familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or member of the assurance team becomes too sympathetic to the client's interests.

v) Intimidation threat occurs when a member of the assurance team may be deferred, from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

QUESTION THREE (*answer similar to Q1 June 2003*)

(a) (i) ISAE 3400, the examination of prospective financial information defines prospective financial information as financial information based on assumptions about future events that may occur in the future and possible actions by the entity.

It is highly subjective in nature and its preparation requires the exercise of considerable judgement. PFI can be in the form of - forecast a projection or a combination of both, for example a one year forecast plus a five year projection.

(ii) In carrying out the review so as to be able to report on the company's forecast, the auditors should pay attention to the following matters.
- The nature and the background of the company's business
- The accounting policies normally followed by the company
- The assumptions on which the forecast is based
- The procedure followed by the company in preparing the forecast.

(b) Procedure to be followed by an auditor in doing a fraud investigation.

INVESTIGATIONS

An investigation can be defined as an enquiry commissioned by a client for some purpose of his. The scope of enquiry, the range of possible clients and the number of purposes can be very large. We shall therefore confine ourselves to the most common types of investigations that the professional accountant may be called upon to do.

Common types of investigations:

i) Acquisition of companies;
j) Purchase of business;
k) Prospective investments;
l) Admission of new partners
m) Prospective lending;
n) Fraud;
o) Systems breakdown;
p) Company acts investigation;

Investigations may be needed whenever facts are in doubt or in dispute or where knowledge is required. Anybody can commission an investigation and you will find that companies, individuals, financial institutions and banks, local authorities, the tax authorities can all commission various investigations.

Investigations: the stages

All investigations are carried out in the same way.

Stage 1: instructions from the client

You must always obtain precise written instructions from the client. This must incorporate a very clear view of the aims of the investigation, the scope of the investigation, the degree of the detail required, the degree of secrecy to be observed, and the person to whom the accountant must address his report. At this level, consideration must be given to the resources the client is ready to utilize and the cost of the job, both in terms of money and time.

Stage 2. Professional courtesies

Professional etiquette requires that if investigations are carried out in the affairs of organizations to whom the accountant is not the auditor then the auditors must be communicated with. This is to observe the usual courtesies and to obtain their cooperation.

Stage 3: organization of the investigation

This involves the accountant assessing the aims of the investigation, estimating the time to be taken and the likely costs and ensuring that the appropriate staff will be available.

Stage 4: obtaining the background information

This is particularly important in investigations in acquisition of business. It involves gathering as much background information as possible about the object of the investigation, the size of the industry and its structure, history since commencement, the future prospects, the relevant

legislation affecting that industry, investment information and relevant accounting ratios. This information is usually available from published sources such as government statistics, trade associations and the financial statements.

Stage 5: gathering preliminary information

This information has to be gathered on the subject to be investigated. This information includes the location of the subject, its products, its range of services and its share of the market, key personnel, major accounting control systems and past reports.

Stage 6: preparing the report outline

A report that meets the needs of many accounting investigations is as follows:

Part A: introduction whereby we have references to the instructions given. The object of the investigation must be apparent from the introduction.

Part B: a summary of the instructions must be given.

Part C: a statement of the precise objectives of the investigation and the report

Part D: a statement of the scope of investigation stating the time, period and the area covered

Part E: a statement of the documents use. If it is necessary to reproduce any of these documents this is usually done in an appendix.

Part F: an outline of the work actually done, again it may be necessary to put some of this material in an appendix.

Part G: a summary of the information obtained.

Part H: further information which could be of use to the client but does not flow from the investigation proper.

Part 1: Recommendations of the accountant. In giving recommendations, the accountant must always ensure that:

j) He gives information from which the client can draw his own conclusions
k) Avoid presenting information in such a way that the client's judgment is influenced.
l) If information is based upon assumptions, then the accountant must state the assumptions in full and substantiate them if possible.
m) Make no forecasts
n) If you are giving opinions, estimates or forecasts, then the accountant must state who made them and what qualifications they had to making them.
o) The recommendations are practical
p) The investigation has been comprehensively completed.
q) The report is drafted and discussed with the client.
r) The final report is submitted.

Stage 7: The investigation proper

Stage 8: Drafting and discussing the report with the client

Stage 9: Finalizing and delivering the report

Stage 10: Being available for further inquiries and investigations.

QUESTION FOUR

(a) Discussion on the responsibility of an auditor with regard to related parties.
ISA 550 (Related parties) defines related party as follow;
Parties are related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. Related party transactions are a transfer of resources between related parties regardless of whether a price is charged.

ISA 550 requires the auditor to perform audit procedures designed to obtain sufficient, appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related transactions that are material to the financial

statements. The auditors knowledge of the client must be sufficient to identify related parties for the following reasons;

- The financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as required IAS 24.
- The existence of related parties or related party transactions may affect the financial statements i.e. tax liability
- The source of the audit evidence affects the auditors assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties.
- A related party transaction may be motivated by considerations other than ordering business considerations. (8 marks)

(b) (i) Factors to consider in deciding on the extent t which you could rely on the work of the auditor of a subsidiary.

- The materiality of the portion of the financial statements which the principal auditor audits
- The principals auditor degree of knowledge regarding the business of the components
- The risk of material misstatement in the financial statements of the components audited by the other auditor
- The performance of additional procedures resulting in the principal auditor having significant participation.
- The principal auditor should consider the competence of the other auditor in the context of the assignment
- Obtain sufficient appropriate evidence that the work of the other auditor is adequate for the principal auditor purpose

ii) When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform, sufficient audit procedures, regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.

If the other auditor issues or intend to issue, a modified auditors report, the principal auditor would consider whether the subject of modification is of such a nature and significance in relation to the financial statements of the entity on which the principal auditor is reporting, that a modification of the principal auditors report is required.

QUESTION FIVE

(a) Work expected to be carried out by the internal auditors of UPS hotel Ltd.

ISA 610 defines internal auditing as a means of appraisal activity established within an entity as a service to the entity. Its function includes among other things, monitoring internal control.

The scope and objectives of internal auditing vary widely and depend on size and structure of the entity and the requirements of its management. Ordinarily, internal auditing activities include one or more of the following:-

- Monitoring of internal control
- Examination of financial and operating information
- Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
- Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

The tribunal report requires;
- Have a defined process for the review of effectiveness of internal control
- Review regular reports on internal control
- Consider key risks and how they have been managed
- Check the adequacy of action taken to remedy weaknesses and incidents.
- Consider the adequacy of monitoring
- Conduct an annual assessment of risks and effectiveness of internal control.

(b) Factors to consider and work to be performed to assess extent of reliance on work of internal auditors.
- The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditors risk assessment. The external auditors assessment of the internal audit function will influence the external auditors judgement about the use to be made of internal auditing in making risk assessments and thereby modifying the nature, extent and timing of further audit procedures.

- When obtaining an understanding and performing an assessment of the internal audit function; the important criteria are the following;
    - Organisational status of the audit function
    - Scope of the internal audit function
    - Technical competence of persons performing internal audit activities

- Evaluation of the work of IA considers whether
    - The work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, renewed and documented.
    - Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions
    - Conclusion reached are appropriate in the circumstance and any reports prepared are consistent with results of the work performed, and
    - Any exception or unusual matters disclosed by internal auditing are properly solved.

(c) Effect of reliance on work of internal audit on audit work
This will affect the nature, extent and timing of audit procedures. It will reduce the amount of work required, the time taken and ultimately the cost of the audit. However, sufficient appropriate audit evidence must still be obtained.

DECEMBER 2005

QUESTION ONE

(a) The test data to be entered into the comprised sales system to check the correct processing of dispatch notes and sales invoices. Test data refers to input data that is input into a computerized processing system to evaluate the processing of data by the system.

The input data may be valid or invalid. For valid test data, the expected results can be calculated in advance and then compared with the results as they arise.

Invalid test data can be used to check whether controls that prevent the input and processing of invalid data are working. This is achieved by entering invalid data, say a non-existent customer code or with an unreasonable amount or transactions which may if processed breach limits such as customer credit limits. Test data may result in corruption of clients data and this should be avoided.

It is also tests the system at a single point in time and this disadvantage can be overcome by use of embedded audit facilities.

Therefore the test data to be used in this case will be valid and then invalid and will cover the following attributes of the customers.

i) Description – Names, address, identity
ii) Credit terms/sales terms
iii) Expected frequency of transactions.
iv) Receipt, invoice and dispatch notes formats and data relevant to complete the forms
v) Taxation details
vi) Sales of various amounts; high and low
vii) Dispatch notes locations and changes for deliveries as applicable.

(b) How a computer program may assist in circularisation of debtors.

i) Stratification of debtors to ensure that on the whole, material amounts are circularized.
ii) Selection of appropriate samples of the debtors to be circularized
iii) Automated ageing of debtors to ensure that extremes are tracked
iv) Easier printing of circularisation letters since the letters and envelope stickers can be automatically generated.
v) Ease of tracking the transaction history of each debtor in case of complaints or disagreements with customers.

Verifying year end receivables

i) Tracking of sales orders to receivables and ensuring that all debtors can be traced to the appropriate sales orders.
ii) Accurate cut off at the balance sheet date both opening and closing balances
iii) Reconciliation of movements in opening and closing balances for each debtor and comparing this with the sales and payment history.
iv) Evaluate the accuracy and reasonableness of doubtful and bad debt provisions
v) Ease of calculation of ratios such as accurate collection periods
vi) Ease of identification of dormant accounts
vii) Ease of identification of debtors write back and write offs and seeking appropriate explanations.

QUESTION TWO

(a) The five key elements of an assurance engagement are:-

i) A three party relationship involving a practitioner, a responsible party and intended users.
ii) An appropriate subject matter
iii) Suitable criteria
iv) Sufficient appropriate audit evidence and
v) A written assurance report in the form appropriate to a reasonable assurance engagement or limited assurance engagement.

(b) Engagement risks that face a professional accountant who accepts an assurance engagement.

Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusions. In reasonable assurance engagements, the practitioner reduces the risk to an acceptably low level in the circumstances of the engagement to obtain assurance as the basis for a positive form of expression of the practitioner conclusion.

In general, assurance engagements can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements

i) The risk that the subject matter information is materially misstated which in form consists of
   - Inherent risk
   - Control risk
ii) Detection risk: the risk that the practitioner will not defect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by engagement circumstances, in particular by the nature of the subject matter and whether reasonable assurance or a limited assurance is being performed.

(c) Why absolute assurance may not be given and circumstances in which reasonable assurance can be given.

ISA 200 (objective and general principles governing an audit of financial statements) states that an auditor can not give or obtain absolute assurance because there are inherent limitations in an audit that affects the auditors' ability to detect material misstatements. These limitations result from factors such as;

- the use of testing
- the inherent limitations of internal control
- the fact that audit evidence is persuasive rather than conclusive.

An auditor's work is also permeated by judgement regarding gathering of audit evidence and drawing conclusions.

Reasonable assurance is a concept relating to the accumulation of audit evidence necessary for the auditor to conclude that there are no material mistatements in the financial statements taken as a whole.

Therefore an auditor provides reasonable assurance when circumstances allow him/her to gather sufficient appropriate audit evidence.

(e) Potential to the independence of a firm involved in assurance engagements.

Independence requires independence of mind and independence in appearance according to the IFACs code of ethics for professional accountants.

Independence is threatened by self-interest, self-review, advocacy, familiarity and intimidation threats.

vi) Self-interest threat occurs when a firm or member of assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client

Example;
- A direct financial interest or material indirect financial interest in an assurance client
- A loan or guarantee from an assurance client or any of its directors and officers.

vii) Self review threat occurs when any product or judgement of previous AE, or NAE needs to be re-evaluated in reading conclusions on the assurance engagements or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct or significant influence over the subject matter of the assurance engagement.

viii) Advocacy threat – occurs when a firm or member of the assurance team, promotes or may be perceived to promote an assurance clients position or opinion to the point that objectivity may or may not be perceived to be compromised.

ix) Familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or member of the assurance team becomes too sympathetic to the client's interests.

x) Intimidation threat occurs when a member of the assurance team may be deferred, from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

QUESTION THREE

(a) Verification that school fees are paid to authorized schools and the existence of students.

i) Obtain a list of authorized schools and ensure that all payments of school fees were only made to schools authorized by the trustees.

ii) Test the numerical sequence of payment vouches and check to approved school fees applications, cheques register/official school receipts and ensure that there is a complete audit trail.

iii) Select a sample of loan applications and compare the information supplied by applicants to reliable third party documents such as school admission letters birth certificates, parents identity card numbers and letter from provincial administrators and ensure that they reasonably agree.

iv) Visit some schools which are authorised and physically request to see the sponsored students and also their school registration details. Also check for how long the student has been receiving the fees.

v) Interview the students as to information in the application forms and whether they provided it.

vi) Obtain the schedules of fees paid and check arithmetic accuracy.

(b) Verification of <u>income</u> from investments.

- Income has been received by the entity and included in the financial statements.

According to ISA 500, management is responsible for the fair prevention of financial statements that reflect the nature and operations of the entity.

Management make assertions, explicit or implicit regarding recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. For income from investments, the following assertions are relevant; occurrence, completeness, accuracy, cut off and classification.

Audit work will include;

i) Obtain a listing of all investments held and confirm that the titles are in the name of the charity

ii) Obtain financial reports of the organisation and firms the charity has invested in and check when dividends were declared and/or paid, when interest was received and any other investment income.

iii) Compare the listing of all investments held and the listing of all income received or receivable by the entity and ensure that all income has been accounted for.

iv) For investment income received, trace the recording of income to the cash book and bank accounts to ensure that all income received was banked and any discrepancies fully investigated.

v) Obtain a detailed listing of all investments and check for changes or movements in balances. Confirm that there were no changes in fixed investment securities and for the shares confirm when the shares were sold and that if any dividends were receivable before the sale that they have been recorded.

For the investments that were purchased, confirm whether it was ex-dividend or cum-dividend and whether it has been recorded appropriately.

vi) Ensure that the documents of title for investments sold and purchased have been transferred.

vii) Ensure that minutes of the meetings that authorised the purchase and sale are available.

viii) Obtain the relevant schedule of income received and ensure that they are arithmetically accurate.

ix) Obtain receipts, interest and dividend warrants at the beginning and at the end of the financial period and confirm that they have been received and recorded in the correct accounting period.

To determine that all investment income had been properly recorded, the auditors would carry out the following work;

i) Check in stock exchange lists or company accounts in respect of unquoted companies to determine the dividends that should have been received in the period.

ii) Obtain information on all bonus and rights issues during the year and investigate action taken and shares received.

iii) Check that the interest due is received on the due date and that it relates correctly to the nominal value of the security

iv) Verify the correctness of calculation and recording of capital gains and losses and their treatment in the financial statements.

v) Review the reasonableness of investment income accounts, taking into consideration the amounts budgeted for and the amounts received in previous year. Material variations would need to be explained, taking into account purchases, bonus issues and sales in the period.

(c) Verify the ownership of fixed interest investments and the shares in listed companies.

i) Inspect share certificates and contract notes. All documents should be inspected together at the same time and should be in the name of the charity.

ii) Examine documentary evidence to verity all purchases and sales during the year, including authorization minutes. Purchase cost and sales income would be vouched and traced to the bank.

iii) Ask third parties holding share certificates pending delivery, whether for sale custody or as collateral, to confirm directly to them their holding on behalf of the client. Verification is unsatisfactory in the following cases and the matter should be referred for action to the audit manager.

- Where stocks are being held by brokers for safe custody and not merely pending delivery (Since brokers are not considered to be appropriate as custodians except in the event of purchase or sale of an investment.)
- Where stock is held in the name of a third party other than a bank nominee, for example a debtor.

iv) Examine board meetings, agreements and supporting correspondence in respect of unquoted shares if any. (Companies which had been quoted may cease being quoted or suspended.)

v) Review investment income received, as it is prima facie evidence of the existence and beneficial ownership of the investments/securities.

QUESTION FOUR

(a) BCD Stores Ltd is a high risk audit client in view of the problems associated with

i) Inventory misappropriation by employees and customers
ii) Slow moving and damaged goods, work less than cost.
iii) Incomplete recording of sales when customers pay by cash

The above are areas of high audit risk and as the manager responsible for the audit, I would consider the following matters and carry out the necessary audit work before the commencement of detailed audit work;

Matters to be considered;

i) The significance and materiality of the audit risk areas
ii) The relevance of the knowledge gained in previous audits and whether any changes have occurred that may affect the relevance of the information to the current audit
iii) Since BCD has high audit risk areas, I will consider the following logistical issues
   - Staffing of the audit – level of qualification, relationship with audit staff, availability, special correct level of experience
   - Client management
   - Locations of the client considering distance to be travelled by audit staff, mobility, determine which location to visit, staff allocations.
   - Deadlines, considering the key dates which the audit team will need to know such as date of inventory count, main audit visit, reviews by managers, draft accounts, date when audit report is signed and date of AGM.
iv) Consider the use of information technology
v) Consider time budgets
vi) Consider other objectives of the audit in addition to the expression of an opinion.

The audit work to be carried out includes;

i) Review client acceptance and continuance relationships and for this specific audit engagements and ethical clearance.
ii) Determine adequate staffing of this audit assignment

iii) Hold meetings to discuss the risk of material misstatement in the areas of risk and its implications for the financial statements.
iv) Determine an appropriate audit strategy. In this audit, a combination of tests of control and extensive substantive testing will be required
v) Review stock taking instructions by the client for adequacy, staffing of the stock take and recommend changes as appropriate.
vi) Review stock taking procedures for identifying obsolete and damaged stock
vii) Discuss with the client and the audit staff to agree on timings for interim vist, final visit and stock take data.
viii) Allocate adequate resources for this audit
ix) Prepare the overall audit strategy and audit plan, document it and communicate with the relevant audit staff
x) Review the internal audit, and decide whether to rely on its work.

(b) Procedures to be carried out to control the audit
i) Communication to the audit staff of the engagement details and ensuring that all logistical arrangements are complete
ii) Ensure that staff follow the detailed audit plans especially in the high audit risk areas.
iii) Review the audit plans and the ICE and ICQs for completion
iv) Consult as necessary with the engagement partner and the clients management in case of any difficulties.
v) Ensure that stock taking instructions are followed, be present at some locations during the stock take and ensure that I test the stock sheets for accuracy.
vi) Review the work done by the internal audit department if we decided to rely on it.
vii) Ensure that deadlines are being met and if not, consult with the client and engagement partner.

QUESTION FIVE

(a) Respective responsibilities of directors and management of a company and its external auditors with respect to financial statements.

ISA 200, explains the respective responsibilities.
The responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance.

The auditor is responsible for forming and expressing an opinion on the financial statements.

The audit of financial statements does not relieve management or those charged with governance their responsibility.

(b) The inherent limitations facing auditors in undertaking their work;

The inherent limitations in an audit of financial statements that affect the auditor ability to detect material mistatements include:-
i) The use of testing
ii) The inherent limitations of internal control (for example, the possibility of management override or collusion)
iii) The fact that most audit evidence is persuasive rather than conclusive
iv) The work is also permeated by judgement
v) Assessing the reliability of estimates made by management

(c) Significant types of judgements made by auditors in:
i) Gathering audit evidence

The work undertaken by the auditor to form an audit opinion is permeated by judgement in particular regarding the gathering of audit evidence, for example in deciding the nature, extent and timing of audit procedures. Also the drawing of conclusions based on the audit evidence gathered for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

ii) Arriving at an opinion in the financial statements

In expressing an audit opinion, the auditor provides uses of financial statements with reasonable assurance that the financial statements are free from material mistatements. In other words, the engagement risk has been minimized to acceptable level. It implies that sufficient appropriate audit evidence has been obtained.
The auditor makes judgements regarding matters affecting or not affecting his audit opinion and also decides on the appropriate forms of the report.

He also considers compliance with laws to satisfy regulatory requirements in a given jurisdiction.

PART III COMPREHENSIVE MOCK EXAMINATION

QUESTIONS - MOCKS

MOCK ONE

QUESTION ONE

Hydrasports, a limited liability company and national leisure group, has sixteen centers around the country and a head office. Facilities at each centre are of a standard design which incorporates a heated swimming pool, sauna, air-conditioned gym and fitness studio with supervised childcare. Each centre is managed on a day-to-day basis, by a centre manager, in accordance with company policies. The centre manager is also responsible for preparing and submitting monthly accounting returns to head office.

Each centre is required to have a licence from the local authority to operate. Licences are granted for periods between two and five years and are renewable subject to satisfactory reports from local authority inspectors. The average annual cost of a licence is Kshs.90,000.

Members pay a Kshs.1,000 joining fee, plus either Kshs.500 per month for 'peak' membership or Kshs.300 per month for 'off-peak', payable quarterly in advance. All fees are stated to be non-refundable.

The centre at Verne was closed from July to September 2003 after a chemical spill in the sauna caused a serious accident. Although the centre was re-opened, Hydrasports has recommended to all centre managers that sauna facilities be suspended until further notice.

In response to complaints to the local authorities about its childcare facilities, Hydrasports has issued centre managers with revised guidelines for minimum levels of supervision. Centre managers are finding it difficult to meet the new guidelines and have suggested that childcare facilities should be withdrawn.

Staff lateness is a recurring problem and a major cause of 'early bird' customer dissatisfaction with sessions which are scheduled to start at 07.00. New employees are generally attracted to the industry in the short-term for its non-cash benefits, including free use of the facilities – but leave when they require increased financial rewards.

Training staff to be qualified life-guards is costly and time-consuming and retention rates are poor. Turnover of centre managers is also high, due to the constraints imposed on them by company policy.

Three of the centres are expected to have run at a loss for the year to 31 December 2003 due to falling membership.

Hydrasports has invested heavily in a hydrotherapy pool at one of these centres, with the aim of attracting retired members with more leisure time. The building contractor has already billed twice as much and taken three times as long as budgeted for the work. The pool is now expected to open in February 2004.

Cash flow difficulties in the current year have put back the planned replacement of gym equipment for most of the centres.

Insurance premiums for liability to employees and the public have increased by nearly 45%. Hydrasports has met the additional expense by reducing its insurance cover on its plant and equipment from a replacement cost basis to a net realisable value basis.

Required:

(a) (i) Identify and explain the business risks which should be assessed by the management of Hydrasports. (8 marks)

(ii) Explain how each of the business risks identified in (i) may be linked to financial statement risk. (8 marks)

(b) Describe the principal audit work to be performed in respect of the carrying amount of the following items in the balance sheet of Hydrasports as at 31 December 2003:
(i) deferred income; and (3 marks)
(ii) Hydrotherapy pool. (3 marks)

(c) Suggest performance indicators that could be set to increase the centre managers' awareness of Hydrasports' social and environmental responsibilities and the evidence which should be available to provide assurance on their accuracy. (8 marks)

(Total: 30 marks)

QUESTION TWO

Taurus Traders

As manager responsible for prospective new clients you have visited Taurus Traders, a limited liability company which supplies a range of specialist materials to the building industry. The chief executive and majority shareholder, Mr. Aquila, has asked your firm to make a proposal for the company's audit and the provision of financial advice.

During your initial meeting you have ascertained the following:

Turnover has grown from Kshs.4 million to Kshs.7 million in the last two years and the company is profitable. Further growth is anticipated as Mr. Aquila has plans:

(a) to increase the company's customer base by making certain materials available to the public through builders merchants and
(b) to expand the product base by setting up an overseas operation to manufactures silicon carbide components.

Mr. Aquila negotiates prices directly with both suppliers and customers. A part qualified accountant was recruited earlier in the year to help with the credit control and to set up more formal accounting systems and procedures. A desk top computer provides basic sales, receivables, and inventory and payroll information. The software was written to Mr. Aquila's requirements by his wife's brother. Most purchases require foreign currency translation and are recorded manually. Each month end there are varying small but unreconciled differences on the receivables and payables ledger control accounts.

The annual budget significantly understates actual revenue and expenses because of higher than expected growth. Management accounts are produced infrequently on an adhoc basis.

For management accounting purposes, cost of sales is calculated as a percentage of sales value for different product categories. Historically, this method has proved reasonably reliable when compared to the year-end valuation of the annual physical inventory count. However margins on product lines have recently become more varied.

Taurus is currently experiencing a high level of returns of faulty materials. These are returned to inventory if they cannot be sold at a discount for cash.

Mr. Aquila is negotiating a bank loan to finance the cost of planned new premises. Contracts with the builders have been signed and building work has commenced. The bank is waiting for a profit forecast before giving final approval to a Kshs.2 million loan.

Taurus traders has increasingly tended to exceed its agreed overdraft facility. Mr. Aquila has indicated that a large receipt from a major customer, expected at the end of next month, is to be used to clear tax payment arrears and repay his loan account of Kshs.52,000.

Mr. Aquila is recently married and has purchased a luxury apartment and a new car. He is dissatisfied with the firm of accountants which currently prepares and audits the annual financial statements. He attributes this is to the firm's failure to reconcile the ledgers. He also claims that the firm has been unable to suggest how his remuneration package can be increased to meet his personal needs.

Required:

(a) Identify and describe the principal business risks relating to Taurus Traders.
(11 marks)

(b) Identify and comment on the factors that should influence the partner in deciding whether or not the firm should make a proposal for this engagement.
(5 marks)

(c) Justify an appropriate audit strategy for the first audit of Taurus Traders.
(6 marks)

(d) Suggest two procedures that Taurus Traders could implement immediately to improve its accounting procedures and financial controls.
(3 marks)

(Total: 25 marks)

QUESTION THREE

You have been approached for advice by the financial director of Image Ltd., a company which sells, rents and services photocopies and facsimile machines. All the company's significant accounting applications are processed on its own minicomputer.

During the preliminary investigation you established that all service calls are logged on sequentially numbered dockets which bear the date of service, time taken, material used and the serial number of the unit repaired.
All details on the docket are captured into the service call billing system.
Billable service calls are identified by the relevant service engineer prior to capture by marking the docket following a manual review of the rental contracts file.
Service calls in respect of rented equipment are provided free of charge. All other services are billable.
The system produces invoices for all service calls identified by the service engineers.
You have been informed that the company's computerized customer rental file contains full details of each rental contract, including equipment serial numbers and rental start and end dates.
A transaction file which records each service call docket for the period under review is retained by the computer department.
The transaction file includes fields which record the billable value of every service docket and an invoice number for those dockets that were invoiced to customers.

Required:

(a) List the main steps to be executed by means of a computer program in order to identify and report service call billing errors by Image Ltd. The program should identify errors that may arise as a result of incorrect identification of billable service calls by the service engineers. Your answer should make reference to appropriate files and fields.
(You are not required to write the computer program)
(10 marks)

(b) List the procedures that should be followed by business with significant in house information systems resources to ensure that all changes to programs are properly controlled. (15 marks)

(Total: 25 marks)

QUESTION FOUR

a) Explain the role of 'support letters' (also called 'comfort letters') as evidence in the audit of financial statements. (5 marks)

b) You are an audit manager in Moltisant, a firm of Chartered Certified Accountants, and currently assigned to the audit of Capri Group. The consolidated financial statements of Capri Group are prepared in accordance with the accounting standards and interpretations issued by the International Accounting Standards Board (IASB). The draft financial statements for the year ended 30 June 2002 show profit before taxation of Kshs.6.2 million (2001 – Kshs.5.5 million) and total assets Kshs.32.5 million (2001 – Kshs.29.8)

One of the Group's principal subsidiaries, Capri (Overseas), is audited by another firm, Marcel. You have just received Marcel's draft auditor's report as follows:

'Basis of audit opinion (extract)
'As set out in notes 4 and 5, expenditure on finance leases has not been reflected in the balance but included in operating expenses and no provision has been made for deferred taxation. This is in accordance with local taxation regulations.

'Opinion
'In our opinion the financial statements give a true and fair view of the financial position of the company as of 30 June 2002 and of the results of its operations and its cash flows for the year then ended in accordance with ……'

The draft financial statements of Capri (Overseas) for the year ended 30 June 2002 show profit before taxation of Kshs.1.9 million (2001 – Kshs.1.7 million) and total assets Kshs.6.5 million (2001 – Kshs.6.6 million). The relevant notes (in full) are as follows:

4) Leased assets

During the year the company has incurred expenditure on leasing agreements that give rights approximating to ownership of fixed assets with a fair value of Kshs.790,000. All lease payments are charged to the income statement as incurred.

5) Taxation

This includes current taxes on profit and other taxes such as taxes on capital. No provision is required to be made for deferred taxation and its is impracticable to quantify the financial effect of unrecognized deferred tax liabilities

Required:

Comment on the matters you should consider before expressing an opinion on the consolidated financial statements of the Capri Group. (10 marks)

(Total: 15 marks)

QUESTION FIVE

If there is a need for a uniform set of international accounting standards and international auditing standards, there is also a need for global corporate governance standards.

Required:
Discuss and reach a conclusion. **(Total: 20 marks)**

MOCK TWO

QUESTION ONE

Your firm has been approached by the managing director of Abacus Leasing Ltd to tender for the audit. The previous auditors have resigned after a loss of confidence in them by the board of Abacus Leasing Ltd. This concerned the disapproval by the board of a qualified audit report issued by the outgoing auditors, which referred to inadequate internal controls in Abacus Leasing ltd systems.

The company leases equipment to building contractors, many of whom have insufficient cash resources to purchase the equipment outright. Some lessees have been refused credit elsewhere. Since formation three years ago Abacus Leasing ltd turnover has doubled each year and lease debtors now represent over 80% of the company's gross assets. The company is now experiencing difficulty in collecting a substantial amount of overdue lease payments. Abacus Leasing ltd has no formal system for approval of new customers or any laid down procedures for the repossession of assets where the terms of the lease agreements have been broken.

Although the terms and conditions of the leases vary considerably Abacus Leasing ltd has treated them all as finance leases.

The company is managed by a Board of three directors with a dominant managing director who owns 95% of the share capital. The directors and senior management are largely remunerated by a performance bonus on new sales. The company does not have an audit committee.

Required:

(a) Describe the procedures an audit firm should undertake before accepting a potentially high-risk audit client such as that of Abacus Leasing ltd. (5 marks)

(b) Describe the factors in relation to the audit of Abacus Leasing Ltd that would affect your assessment of the inherent risk. (7 marks)

(c) Describe the audit work that you would undertake to determine the correct accounting treatment and disclosure of

(i) The leases
(ii) The bad debts provision in respect of lease debtors. (8 marks)

(Total: 20 marks)

QUESTION TWO

Midland Builders

An unmodified audit report normally states that the financial statements to which the report refers give a true and fair view of the state of the company's affairs at the balance sheet date and of is profits for the year ended on that date.

Bearing in mind the above statement, the directors of Midland Builders, a limited liability company, have drawn up accounts for the year ended 30 April 209x7 which do not reflect certain events which have occurred since the year end. They justify their action on the grounds that the books and records correctly reflect what was known at the year-end.

The following are the events which are not reflected in the draft financial statements
(in all cases the figures are material).

(a) At a meeting in MAY 20X7 the local planning authority rejected the company's plans to develop one of its freehold sites. The site was included in the company's assets at its cost of Kshs.50,000 but it is likely that the site will have to be sold and realize no more than Kshs.35,000 because of its reduced development potential.
(b) Following the completion of a long term contract in June 20x7 it has been possible to calculate the final profit on the contract. It appears that the profit accrued at 30 April 20x7 was underestimated by Kshs.20,000. This arose from material error at 30 April 20x7 in estimating the amount of work still to be completed.
(c) A public company in which Midland Builders held shares as a long term trade investment announced in June 20x7 that it was going into liquidation. The investment is shown in the balance sheet at it historical cost of Kshs.40.000 and a note of its stock market value at 30 April 20x7 of Kshs.46,000 is included in the notes to the accounts. It now appears likely that the investment will prove worthless.

Required:

(a) Discuss generally the effect which facts and events relating to a period but becoming known or occurring after the end of an accounting period can have on the financial statements for the period in question. Comment on the directors view that the books and record reflect what was known at the year end and that therefore no further adjustments are required.
(b) List FOUR detailed procedures which an auditor should adopt in order to detect events after the balance sheet date.
(c) In respect of each of the three event descried above, list the detailed work which the auditor should undertake and comment on the acceptability of the company's decision not to adjust its financial statements.

(i) Refusal of planning permission (4 marks)
(ii) Completion of long term contract (5 marks)
(iii) Liquidation of trade investment (3 marks)
(Total: 20 marks)

QUESTION THREE

Farrington Ltd

You are the manger in charge of the audit of Farrington Ltd. a company which manufactures biscuits and confectionery. You wish to employ a junior member of staff to audit the trade creditors, accruals and provisions as shown in the balance sheet at the year end and are in the process of preparing audit programmes which clearly explain the purpose and extent of the work at each stage of the audit.

The draft figures for 'creditors – amounts falling due within one year' as at 31 October 2004 (with 2003 comparative figures) are as follows:

	31 October	
	2004	2003
	Kshs.	Kshs.
Trade creditors	261,521	177,625
Sundry accruals	21,162	18,177
Provisions – Legal action *	40,000	-
- Factory repairs **	72,000	62,000
	394,683	257,802

* This provision related to a legal action brought by a competitor who claims their manufacturing process has been illegally copied

** This provision which was fist set up in 1984 relates to sums required to be spent on urgent repair to the factory foundations and structural steel work. (Kshs. 58,500 was spent during the year ended 31 October 2004).

Required

For Farrington Ltd., set out in tabular form (with explanation of the purpose of each stage) outline programmes for the audit of:

a. Trade creditors (8 marks)
b. Sundry accruals (4 marks)
c. Provisions 4 marks)
(Total: 16 marks)

QUESTION FOUR

Sampling

It is important to recognize that audit sampling may be constructed on a non-statistical basis. If the auditors use statistical sampling, probability theory will be used to determine sample size and random selection methods to ensure each item or 1 in value of the population has the same chance of selection. Non-statistical sampling is more subjective than statistical sampling, typically using haphazard selection methods and placing no reliance upon probability theory. However, in certain circumstances statistical sampling techniques may be difficult to use. The auditors will review the circumstances of each audit before deciding whether to use statistical or non-statistical sampling.

Required:

(a) List three situations where the auditors would be unlikely to use audit-sampling tec

(b) Explain what you understand by the following terms
  (i) Attribute sampling
  (ii) Monetary unit sampling

(c) Describe the factors which the auditors should consider when determining the size of a sample.
(d) Describe to what extent statistical sampling enhances the quality of the audit evidence.

QUESTION FIVE

Lenton Textiles ltd

Your firm is the auditor of Lenton Textiles ltd and you have been asked to suggest the audit work, which should be carried out on the sales system.

Lenton Textiles ltd sells textile products to shops. Most of its sales are made on credit, but very small customers who do not have a sales ledger account can collect their purchases and pay in cash. For these cash sales, the customer:

(a) Orders the items from the sales department, which raises a pre numbered multi copy advice note;
(b) The dispatch department make up the order and give it to the customer with a copy of the advice note;
(c) The customer gives the advice note to the cashier who prepares a hand written sales invoice;
(d) The customer pays the cashier for the goods by cheque or in cash;

(e) The cashier records and banks the cash.

For credit sales, cheques and cash are received in the post. The post is opened by two people, who record cash and cheques received. The cheques and cash are given to the cashier who records them in the cashbook and pays them into the bank. The cashier reports the cheques and cash received to the sales accounting department, which posts the items to the sales ledger.

Credit notes must be authorized before they are sent to customers and posted to the sales ledger.

Required:

(a)

- State the weaknesses in the cash sales system
- Describe the systems based tests you would carry out to check there is no material fraud or error in this system.

(b)

- Briefly explain why two people should open the mail, which contains cheques and cash customers.
- Describe the audit work you would carry out when you attend the opening of the mail and follow through the process to banking of the cheques.

(c)

- List the reason why credit notes may be issued.
  Describe the audit work you would perform to check that all credit notes have been authorized and issued for a valid reason.

MOCK THREE

QUESTION ONE

MEADOW

You are an audit manager in Robert Bracco, a firm of Chartered Certified Accountants. One of your audit clients, Meadow, is a company listed on a stock exchange with a 30 September accounting year end. The principal activity of Meadow is retailing under the Vazandt brand name. The retail industry has recently suffered from a reduction in consumer spending.

Meadow has two operating divisions: Domestic and International. Each retail division is sub-divided into four business units: Ladieswear, Menswear, Home furnishings and Foods. The International retail business consists of three broad geographic areas: Africa, South America and the Far East. Robert Bracco is represented by affiliated offices in allrelevant countries.
You have obtained the following information from Meadow's draft financial statements:

(1) Financial extracts	For the year ended 30 September	
Income Statement	2002	2001
	Kshs	Kshs
Turnover	2,585·0	2,638·8
Total operating profit	129·1	120·0
Provision for loss on operations to be discontinued (Note i)	(83·8)	–
Finance cost (net)	(4·7)	(4·8)
Profit before tax	40·6	115·2

	As at 30 September	
Balance sheet	**2002**	**2001**
	Kshs	Kshs
Tangible non-current assets		
Land and buildings	950·5	964·0
Store fit out, fixtures and equipment	448·9	481·8
Inventory (Note ii)	164·2	165·9
Trade and other receivables	22·5	36·9
Cash and cash equivalents	53·7	104·6

Notes:

(i) The company has announced its intention to close loss-making businesses in Africa, subject to the full consultation that the Board recognises will need to take place. The decision to close would be taken only after consultation with employee representative bodies and if no other solution is found during the consultation. Net closure costs of Kshs83·8m have been provided, covering future trading losses, losses on disposal of assets and redundancy costs.

(ii) Inventory is valued at the lower of cost and net realisable value using the retail method (i.e. by reducing sales value by the appropriate percentage gross profit margin).

(2) Segment information

	Turnover		Operating profit	
	2002 Kshs	2001 Kshs	2002 Kshs	2001 Kshs
International				
Africa	99·0	96·7	(11·8)	(9·0)
South America	264·0	250·5	11·1	5·3
Far East	38·3	38·9	2·8	(1·2)
Total International	401·3	386·1	2·1	(4·9)
Domestic	2,183·7	2,252·7	127·0	124·9
Total operating activities	2,585·0	2,638·8	129·1	120·0

	Number of stores	
	2002	**2001**
International		
Africa	4	13
South America	86	87
Far East	4	4
Total International	104	104
Domestic	107	106
Total	211	210

(3) International restructure

On 29 September 2002, the company announced the intention to:

– close all African operations (representing 14 stores); and
– sell the South American businesses.

Required:

(a) Using the information provided, identify and explain the principal audit risks and other matters to be considered when planning the approach to the final audit of Meadow for the year ended 30 September 2002. (17 marks)

(b) Describe the audit work that you would undertake to determine whether the accounting treatment and disclosure for the:
(i) segment information; and
(ii) international restructuring; are appropriate. (8 marks)

(Total: 25 marks)

QUESTION TWO

You have been asked by the senior in charge of the audit of Ringham Manufacturing ltd to describe certain aspects of the work you will carry out in auditing the company's wages system. Employees of Ringham Manufacturing are paid on the basis of hours worked and quantities produced. The hours worked are recorded on clock cards and the quantities produced are confirmed by the foreman. Wages are paid in cash each Friday for the previous week's work. Appointment of employees is authorized by the managing director and the personnel department maintains employee's records and their rates of pay. The cashier is separate from the wages department.

Previous years audits have highlighted weaknesses in internal controls in the company's wages system. This has allowed an employee in the wages department to perpetrate a fraud by creating fictitious employees on the payroll and misappropriating the wages. Thus, some of your audit test have been designed to detect whether this fraud is still taking place.

A 'starters and leavers test' is carried out to ensure that employees are not paid before they commence employment or after they have left.

Required:

(a) State the principal controls you would expect to exist in a wages system and explain their purpose.
(b) Assuming you decide not to attend the wages pay out, suggest other techniques you can use to check the existence of employees.
(c) Describe how you will carry out a starters and leavers test.
(d) Describe the analytical review techniques you can use in auditing the wages system. This should include suggesting any ratios you would calculate.

QUESTION THREE

You are a partner in an established practice . Mr Brown, a director of Brown Keer Ltd approached you to investigate a suspected computer fraud in his company. The company supplies civil engineering services to the public and private sector. Most of his work is done through subcontractors and as many as 100 subcontractors may be working on projects at any one time.

The company commenced business five years ago with about 15 employees and has since grown rapidly. It currently employs 600 permanent staff.

As a result of the rapid expansion of the company, the accounting systems were computerized in 20X4 and have since been upgraded and improved. At the end of 20X4 the company discontinued cheque payments to sub contractors and instituted the method pf direct payment through the banking system. Since then, the engineers in charge of the various projects have sent facsimile copies of engineering certificates of work completed through to the head office in Nairobi. These are received by the 22-day of each month and serve as the authorization document for updating sub contractors accounts. All contract work certified in this way is processed by the 25 day of each month. A magnetic tape containing complete details of the payments to sub contractors is delivered the following day to the company's bank. The bank processes the relevant data and passes the payments for the credit of sub contractors' accounts through to the relevant banks for batch processing during the evening of the 27th day of each month. Each sub contractor's bank account is thus credited by the morning of the 28th day of each month with an amount equal to the value of work certified up to the 22nd day of that month. From your discussion with Mr. brown you establish the following:

1. Mr. Solo, a sole practioner has been the auditor of Brown Keer Ltd since its incorporation.
2. The engineer in charge of one of the large projects recently requested a complete project cost analysis after he had been questioned by management regarding excessive expenditure compared with the original tender. He subsequently established that a number of fictitious sub contractors had been paid for work that had not been certified. Further investigations revealed that fraudulent engineering certificates had been received for processing from the Mombassa office. Provisional investigations indicate that the fraud started early 20X5.
3. Mr. Solo issued audit reports for the years ended 31 March 20X5 and 31 march 20X6 and has not brought any in the company's internal control system to the attention of the management during the years covered by those audits.
4. Mr. Solo has been informed of the suspected fraud but he is unable to undertake the investigation immediately as he does not have available staff.

Required:

a. State in point form the factors you must consider and the procedures your firm must follow before accepting this assignment; (6 marks)
b. Describe the internal control weaknesses and accounting problems that can normally be expected in circumstances where a small company grows rapidly. (8 marks)
c. List the main controls, which could have assisted in the prevention or timely detection of fraud such as that which took place in the circumstances outlined above. (9 marks)

(**Total: 23 marks)**

QUESTION FOUR

Two important communications between the auditors and the management or board of directors of the client entity are commonly referred to as letter of representations and the management report or letter of weaknesses. Both communications are referred to in ISA210. Terms of audit engagement. The letter of representation is additionally the subject of ISA 580 management representations and the management report is referred to in ISA 400 risk assessments and internal control.

Required:

a) Letter of representation

i. Explain the purpose of the letter of representation and the extent to which it constitutes sufficient appropriate audit evidence. (5 marks)
ii. Describe three matters you might find in a letter of representation (other than acknowledgement by the management of its responsibility for the financial statements) (3 marks)
iii. Explain the effect on the audit if the management refuses to make one or more of the representations requested.

b) Management report

(i) Describe the procedures associated with the communication of control weaknesses of management relating to: -
- Timing of the communication
- Method of communication
- Level of management to which communication should be made.

(4 marks)

(ii) Discuss the extent of the auditor's responsibility for detecting and reporting internal control weaknesses. (5 marks)

QUESTION FIVE

Recently the central bank of Kenya issued a guideline to banks and non-bank financial institutions advising them to consider setting up Audit Committees.

You are required to set out below: -

a) The purpose and objectives of an audit committee. (5 marks)
b) Composition of audit committee (2 marks)
c) Responsibilities of an audit committee (6 marks)
d) The relationship between the audit committee and the external auditors (2 marks)
e) The relationship between the audit committee and the board of directors (2 marks)

(Total: 17 marks)

MOCK FOUR

QUESTION ONE

AMBER PAN EUROPE

You are an audit manager in Riebect & Co. a firm of Chartered Certified Accountants. One of your audit clients, Amber Pan Europe ('Amber') a listed company with a 30 June accounting year end, provides wirefree communications services in a rapidly growing market.

In August 2001 Amber purchased Talc, a competitor group of companies. Significant revenue, cost and capital expenditure synergies are expected as the operations of Amber and Talc are being combined into one group of companies.

The following financial and operating information consolidates the results of the enlarged Amber group:

	Year end 30 June	
	2002 (Estimated)	2001 (Actual)
	$m	$m
Revenue	7,585	4,893
Cost of sales	(3,454)	(2,212)
Distribution and administrative costs	(3,184)	(1,889)
Research and development costs	(28)	(24)
Depreciation and amortisation	(1,030)	(735)
Finance cost	(296)	(224)
Loss before taxation	(407)	(191)
Customers (in thousands)		
Contract (Note 1)	8,861	5,914
Prepaid (Note 2)	6,084	1,688
Average revenue per user (APRU)		
Contract	655	714
Prepaid	241	283

Notes:

1. Contract customers have specified minimum terms and monthly subscription charges.
2. Prepaid customers have no monthly subscription charges and pay for airtime through refill cards/vouchers

In may 2002 Amber purchased Socolla, a large mobile phone network operator in East Africa, where your firm has no representation. The financial statements of Socolla for the year ended 30 June 2002 will continue to be audited by a local firm of Chartered Certified Accountants. Socolla's activities have not been reflected in the above estimated results of the group. Amber is committed to introducing its corporate image into Africa.

In order to sustain growth, significant costs are expected to be incurred as operations are expanded, networks upgraded and new products and services introduced.

Required:

a) Identify and describe the principal business risks for the Amber group (8 marks)

b) Explain what effect the acquisitions will have on the planning of Riebeck's audit of the consolidated financial statements of Amber for the year ending 30 June 2002 (10 marks)

c) Describe how analytical procedures may be used in the audit of Amber for the year ending 30 June 2002 (7 marks)

(Total: 25 marks)

QUESTION TWO

Aspersion

You are the manager responsible for the audit of Aspersion, a limited liability company, which mainly provides national cargo services with a small fleet of aircraft. The draft accounts for the year ended 30 September 2001 show profit before taxation of Kshs2·7 million (2000 ñ Kshs2·2 million) and total assets of Kshs10·4 million (2000 ñ Kshs9·8 million). The following issues are outstanding and have been left for your attention:

(1) The sale of a cargo carrier to Abra, a private limited company, during the year resulted in a loss on disposal of Kshs400,000. The aircraft cost Kshs1·2 million when it was purchased in October 1992 and was being depreciated on a straight-line basis over 20 years. The minutes of the board meeting at which the sale was approved record that Aspersionís finance director, Iain Jolteon, has a 30% equity interest in Abra. (7 marks)

(2) As well as cargo carriers, Aspersion owns two light aircraft which were purchased in 1998 to provide business passenger flights to a small island under a three year service contract. It is now known that the contract will not be renewed when it expires at the end of March 2002. The aircraft, which cost Kshs450,000 each, are being depreciated over fifteen years. (7 marks)

(3) Deferred tax amounting to Kshs570,000 as at 30 September 2001 has been calculated relating to tangible non-current assets at a tax rate of 30% using the full provision method (IAS 12 ëIncome Taxesí). On 1 December 2001, the government announced an increase in the corporate income tax rate to 34%. The directors are proposing to adjust the draft accounts for the further liability arising. (6 marks)

Required:

For each of the above points:

(i) Comment on the matters that you should consider; and

(ii) State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Aspersion. **(Total: 20 marks)**

NOTE: The mark allocation is shown against each of the three issues.

QUESTION THREE

You are the auditor of Beeys Ltd., a manufacturing company whose raw material and other requirements are provided mainly by domestic suppliers.

For the year ended 31 December 1994, you relied for audit purposes, primarily on an appropriate division of duties and sound basic internal controls over the manual systems for the recording of purchases and for the payment of creditors by cheque.

With effect from 1 January 1995 the company opened a separate bank account at the AD Bank Ltd. for the settlement of creditors' accounts. Since that date the company has been linked with AD bank's mainframe computer by means of a dial up link to microcomputer at the head office of Beeys Ltd. Beeys Ltd., now uses the dial up link to access an electronic funds transfer facility in order to pay its suppliers.

You have been informed that Jooste Stores Ltd., a retail chain, which is a major customer of Beeys ltd., has announced its intention of encouraging Beeys ltd. to join an Electronic Data Interchange (EDI) network. The EDI network will enable Jooste Stores Limited to submit orders to Beeys Ltd. electronically and that Beeys Ltd. will be able to invoice Jooste Stores Ltd. via the EDI network.

You are planning the audit of Beeys Ltd. for the year ending 31 December 1995.

Required:

List in connection with your audit:

(a) The programmed access controls you would expect to have been incorporated into the electronic funds transfer system used by Beeys Ltd. (9 marks)
(b) The additional measures that Beeys Ltd. should take in order to prevent unauthorized transfers. (8 marks)
(c) Outline briefly the most important risk to which Beeys Ltd. would expose itself by joining EDN Network. (8 marks)

(Total: 25 marks)

QUESTION FOUR

You are responsible for the completion of the fieldwork of the audit of Macho Ltd., a private company manufacturing domestic and industrial cleaning appliances. The draft accounts have been presented to you as follows:

Macho Ltd. Balance Sheet as at 30 November 1993

	1993 Sh. '000'	1993 Sh. '000'	1992 Sh. '000'	1992 Sh. '000'
Fixed assets		11,050		3,250
Current assets				
Stock and work in progress	6,695		5,980	
Debtors	15,860		15,015	
Cash at bank	4,745		6,435	
	27,300		27,300	
Creditors: amounts				
Falling due within one year	25,415		24,635	
Net current assets		1,885		2,795
Total assets less current liabilities		12,935		6,045
Capital and reserves				
Called up share capital		650		650
Profit and loss account		12,285		5,395
		12,935		6,045

The profit before tax was Sh.6,890,000 on a turnover of Sh.97.5 million for the year ended 30th November 1993.
The audit tests have been completed. It only remains for you to assess their impact on the draft accounts and to report your findings to the partner in charge.
(No adjustments have been made to the draft account other than as indicated below).

The findings are as follows:

(a) Cheques to suppliers amounting to Sh.661,180 had been drawn on the last day of the financial year. Due to a clerical error they had not been mailed until several days after the year-end.
(b) An updated price list was issued in early November 1993 to take effect form 1 December 1993. A number of invoices were issued during November using the new higher prices. Your client became aware of this after the year-end. A provision was set up against debtors in the draft accounts to account for the credit notes which would have to be issued as a result after the year end. The client's estimate of the extent of the credit notes required was Sh.650,000 and provision was made for this amount. Your audit test show that in the event Sh.1,140,230 in credits was issued after they year end in respect of these pricing errors.
(c) Additions to plant and machinery totaled Sh.3,380,000 during the year. To verify their validity a representative sampling test was conducted, selection being on a random basis. The value of the sample was Sh.845,000. A number of repair items (total value Sh.162,500) was found to have been incorrectly included in additions. When this was brought to the client's attention these items were corrected in the draft accounts.
(d) Toward the end of the year, the company had begun to purchase component parts from Italy. The goods were invoiced in Lire. At the end of the year a number of these items were ins tock and were included in the draft accounts using the year and exchange rate for Lire. Your stock valuation checks showed that there had been negligible movement in the rate for Lire in the period between delivery and payment for the goods shortly after the year ended.
(e) Appliances are sold under a two-year warranty. At each year-end the company makes estimates of how much should be provided for repair work to be conducted under warranties issued but not claimed against. Client's management accepts that this is a subjective area but feel that their estimates, based on the sales volume, rates of claim and average repair cost, are responsible. Your workings suggest that the provision which stands at Sh.1,625,000 needs to be at least that much and might be as much as Sh.325,000 understated.. Your client disagrees stating that you are taking too pessimistic a view.
(f) You note that your client has continued to include among the creditors an 'uninsured risk' provision of Sh.1,300,000. Reference to the previous year's files indicates that this provision was set up a number of years ago to provide against 'unforeseen events' but as yet no amounts have been charged against it.

Write a file note for the partner in charge of the audit which:

(a) Briefly discusses the issues raised by these findings (15 marks)
(b) Summarizes their financial impact on the draft accounts (6 marks)
(c) States the action you would require before you would recommend the issues of an unqualified audit report. (3 marks)

NOTE: Ignore taxation **(Total: 24 marks)**

QUESTION FIVE

Audit Failures

There is no doubt that the auditing profession is damaged when auditors give a stamp of approval to the financial statements of a well known company which subsequently collapses.

Required:

Discuss the ways in which the auditing profession could respond to the issues raised by possible audit failures. . **(Total: 20 marks)**

MOCK FIVE

QUESTION ONE

Computer Maintenance Services Ltd. are computer Engineers with a current annual turnover of Sh.8,000,000. Generally customers are invoiced for maintenance work at the time that service is provided although the company offer their customers a three year service contract on payment of a non-refundable fixed sum at the beginning of the contract.

You have been appointed auditor, your predecessors having resigned after completing the audit for the year ended 30 September 1989. Their report was unqualified.

You have commenced planning the audit of the financial statements for the year ending 30 September 1990 and have found that on the basis that payments for three year service contracts are non-refundable, the directors have in previous years taken credit for all such income at the time that the contract is entered into.

The management accounts for the year to date show that direct costs represent approximately 80% of the service contract income. The net profit for the year ended 30 September 1989 was Sh.480,000 and income from service contracts entered into during that year amounted to Sh.2,150,000.

You are required to write a formal letter to the directors setting out:

(a) Your reservations, if any, on the accounting policy adopted for three year service contracts, and

(b) Your recommended treatment of such income, together with the disclosures you consider necessary in order for the financial statements to show a true and fair view.

(Total: 16 Marks)

QUESTION TWO

Azure sells inclusive tours (i.e. international flights, hotel accommodation and meals) to two million customers. All hotels are independently owned and operated. The company employs 5,000 people and uses 11 leased aircraft. Azure has a representative office at each of 13 holiday locations. Your firm has been invited to tender for the audit of Azure for the year ending 31 December 2002. As the prospective audit engagement manager, you have been asked to identify the principal audit risks and other planning issues, including audit strategy, to be presented as part of your firm's written submission. The invitation to tender indicates that written submissions will be used as a means of short listing for the presentation for the presentation stage.

You have obtained the following information from Azure's Annual Report 2000:

a. Holidays are sold through Azure's retail travel agency, IsoTours, which has 29 outlets (1999:31). Direct sales through call centres is the fastest growing distribution method and internet bookings are now offered.
b. The internal financial control system includes:

   i. Divisional planning and budgeting systems and regular Board reviews of actual results compared to budget and prior year comparatives;
   ii. An internal audit function and a review of internal audit reports by the Audit Committee.

3) Financial extracts ($m):

	2000	1999
Turnover (Note i)	942.8	763.7
Operating profit before tax	27.3	25.7
Tangible non-current assets	109.1	80.3
Trade receivables	29.7	18.2
Cash and cash equivalents	138.6	91.0
Current liabilities (Note ii)	(237.2)	(200.5)
5% Convertible debt due 2005 (Note iii)	(73.0)	-

Notes:

a. Turnover represents gross revenue receivable from inclusive tours and travel agency commissions. Revenues and expenses relating to inclusive tours are taken to the Income Statement on holiday departure.
b. Revenue received in advance included in current liabilities amounts to $69.9 million (1999: $61.4 million).
c. Debt will be redeemed at its principal amount on 7 January 2005 unless it is converted at the option of the debt holder any time before 31 December 2004
d. Annual commitments under non-cancellable operating leases are as follows ($m):

	2000	1999
Less than one year	4.3	2.5
Between one and five years	16.7	17.9
Five years or more	17.4	12.7
	38.4	33.1

Required:

a) Explain the audit planning issues which should be included in the written submission as requested by Azure (15 marks)

b) Suggest and comment on appropriate selection criteria which should be used by Azure in its evaluation of submissions received. (10 marks)

(Total: 25 marks)

QUESTION THREE

You are the auditor of Progressive Investments Limited, a company operating a chain of twelve stores in the country with a total turnover in the region of Sh.150 million per annum and employing approximately 120 staff. The Finance Director has informed you that the company is to set up an internal audit department responsible to him with a staff of three. They are to be responsible for reviewing and recommending improvements to the systems of internal control. In addition the finance director has suggested that in order to improve existing systems of internal control the internal audit department would be required to authorise all payments over a specified limit, the payment of salaries to all staff and the issue of credit notes.

You are required to write a formal letter to the finance director commenting on the extent to which you would be prepared to rely upon the work of the internal audit department in carrying out your audit of the accounts of Progressive Investments Limited. **(Total: 16 Marks)**

QUESTION FOUR

The main computer audit techniques which make use of a computer are test packs and computer auditing programs.

(a) Discuss the limitations of these two techniques. (10 Marks)

(b) Describe six input control techniques which can be incorporated into a computer operational program. (6 Marks)

(Total: 16 Marks)

QUESTION FIVE

Auditors and Auditing standards are controlled and regulated in a number of different ways.

Required

a) Explain how international Standards on auditing (ISAs) are developed by IAASB and explain the role and authority of ISAs. (8 marks)

b) Explain the role of professional bodies in the regulation of auditors (8 marks)

c) Describe how ISAs and national auditing standards in some individual countries influence each other. (4 marks)

(Total: 20 marks)

ANSWERS – MOCKS

MOCK ONE

QUESTION ONE

HYDRASPORTS
(a) (i) Business risks **(ii)** Financial statement risk

Tutorial note: *As part (ii) is clearly related in the requirement to part (i), it is appropriate that a 'tabular' approach be adopted.*

The standard design of facilities increases operational` risk as any difficulties encountered in one facility will be compounded by the number of other facilities (potentially all) which are similarly affected. This is illustrated by the closure of the saunas.

Tutorial note: *Standard design may also reduce risk as it results in a higher quality 'product'.*

- The carrying amount of the associated non-current assets (i.e. equipment, fixtures and fittings) is likely to be overstated as they are likely to be impaired if they are not in use.
- Centralised control through company policy is resulting in inefficient and ineffective operations as managers cannot respond on a timely basis to local needs.
- Management circumvention or override of control procedures laid down by head office may result in system weaknesses. If errors arising are not detected and corrected the risk of misstatement in the financial statements is increased.
- Business reporting risk is likely to be increased by centre managers preparing monthly accounting returns. Operational risk may be increased if centre managers cannot fulfil their day-to-day responsibilities (e.g. relating to customer satisfaction, human resources, health and safety).
- Information processing risk is increased as accounting information flowing into the financial statements may not be properly captured, input, processed or output by the centre managers.
- Inherent risk, of errors arising, in monthly 'branch' returns is high.
- Advanced payments contribute to business reporting and financial (cash flow) risk. Cash received must be available to meet the costs of providing future services.
- Revenue may be overstated if an accurate cutoff is not achieved. In particular, there is an estimate risk in determining the amount of deferred income at the balance sheet date. An error of principle may also arise if Hydrasports' revenue recognition policy does not comply with IAS 18 'Revenue'.
- Hydrasports cannot operate a centre if a licence is suspended, withdrawn or not renewed (e.g. through failing a local authority inspection or failing to apply for renewal).
- An error of principle arises if licences are not capitalized as intangible assets (but instead written off as expenses when incurred).
- Intangible assets (licences) should be reviewed for impairment at each balance sheet date (e.g. for centres which are closed).
- Closure may result in customers finding alternative facilities with permanent loss of fee revenue.
- 'Early bird' customers dissatisfaction similarly increases operational risk.
- Failure risk (i.e. that Hydrasports will not continue to operate as a going concern) is increased.

- This creates disclosure risk if the disclosures relating to going concern as the basis of accounting do not meet the requirements of IAS 1 'Presentation of Financial Statements'.
- Serious accidents may prompt investigation by local authority – resulting in penalties, fines and/or withdrawal of license to operate.
- If licences are withdrawn, the intangible asset (amounts prepaid) should be written off to the extent that monies are not refundable.
- The likelihood of contingent (if not actual) liabilities increases disclosure risk.
- Although fees are non-refundable, suspension of a facility (e.g. sauna) may result in customers asking for partial refund. In particular Hydrasports may have an obligation to refund fees paid in advance when centres are closed (e.g. the Verne centre from July–September 2003).
- Provisions may be understated at 31 December 2003 if Hydrasports has a legal obligation to refund fees where it has failed to provide services.
- Permanent loss of customers requiring childcare facilities increases operating risk. Compliance risk is increased if the new guidelines are not met.
- Similarly, inability to retain lifeguards increases operational risk that pools cannot open (due to health and safety regulations). Compliance risk is increased by the possibility that pools may be operated without a lifeguard being on duty.
- Disclosure risk is (again) increased if fines/penalties arising are material and not disclosed.
- High staff turnover indicates increased operational risk (poor human resource management, inefficiency in working practices, reduced capacity, etc).
- Staff costs may be overstated as the risk that payments may be made to leavers is increased.
- Limitations on centre managers' levels of authority may not be commensurate with their responsibilities. Empowerment risk arises if managers are not properly led (and if they, in turn, do not properly lead their centre staff).
- Any lack of integrity may increase the risk of management and/or employee fraud, illegal acts and unauthorised use of company assets. In particular the assertion of existence of assets may be at risk (resulting in overstatement).
- More centres may become loss-making if the reasons for falling membership are not addressed.
- Loss-making centres should be tested for impairment as cash-generating units.
- The hydrotherapy pool cannot operate until construction is completed and completion may be threatened by cash flow difficulties.
- The value of the asset in construction should be written down if it is impaired (even though it has not yet been brought into use).
- Cash flow difficulties increase liquidity/financial risk. See above reference to going concern and disclosure risk.
- Obsolete gym equipment increases operational risk as customer satisfaction decreases and health and safety risks are increased.
- Depreciation may be overstated if Hydrasports continues to calculate depreciation on fully-depreciated assets.
- Disclosures for capital commitments (e.g. to replace equipment) in the financial statements may be inappropriate if Hydrasports does not have funds to finance such commitments.
- The reduction in insurance cover reduces the recoverable amount of assets in the event of loss through fire (for example). Inability to replace lost/damaged assets increases operational risk (see obsolete gym equipment above).
- See above reference to going concern and disclosure risk.
- Operational risk is increased if the substantial increase in liability insurance premiums is a reflection of an increase in the level of claims being made.

- Disclosure risk is increased in relation to contingent assets (for reimbursement under insurance policies).

(b) Principal audit work

Deferred income

- Agreeing Hydrasports' analysis of joining fee and peak/off-peak membership fees on a sample basis.
  Tutorial note: *Initial joining fees should not be deferred but recognised when received.*
- Reconciling membership income to fees paid. If customers can renew their membership without payment there should be no deferral of income (unless the debt for unpaid fees is also recognised).
- Assessing the collectibility of unpaid fees (if any) by reviewing after date receipts and correspondence with members.
- Recomputing the deferred income element of fees received in the three months before the balance sheet date.
- Comparison of year-end balance with prior year and investigation of variance.

Hydrotherapy pool

- Verifying the initial cost of this constructed asset will include an examination of:
  - the contract with the builder
  - contractors billings; and
  - stage payments.
- Hydrasports is likely to be advised by its own expert (a quantity surveyor) on how the contract is progressing. Audit work will include a review of the expert's assessment of stage of completion as at the balance sheet date, estimated costs to completion, etc.
- Physical inspection of the construction at the year end to confirm work to date and assess the reasonableness of stage of completion.
- Borrowing costs associated with this substantial ('heavy') investment should be agreed to finance terms and payments. The calculation of any amount capitalised should be recomputed to confirm accuracy.
- The basis of capitalisation, if any, should be agreed to comply with IAS 23 'Borrowing Costs' (e.g. interest accruing during any suspension of building work should not be capitalised).
- As the construction has already cost twice as much as budgeted, its value in use (when brought into use) may be less than cost. Management's assessment of possible impairment (of the hydrotherapy pool and the centre) should be critically appraised.

Tutorial note: *The asset should not yet be subject to depreciation as it has still to be brought into use.*

(c) Performance indicators – social/environmental responsibility

Member satisfaction

- Number of people on membership waiting lists (if any).
- Number of referrals/recommendations to club membership by existing members.
- Proportion of renewed memberships.
- Actual members: 100% capacity membership (sub-analysed between 'peak' and 'off-peak').

Membership dissatisfaction

- Proportion of members requesting refunds per month/quarter.
- Proportion of memberships 'lapsing' (i.e. not renewed).

Staff

- Average number of staff employed per month.
- Number of starters/leavers per month.
- Staff turnover/average duration of employment.

- Number of training courses for lifeguards per annum.
- Average hourly (weekly) wage: average national hourly (weekly) wage (or national minimum).

Predictability

- Number of late openings (say more than 5, 15 and 30 minutes after advertised opening times).
- Number of days closure per month/year of each facility (i.e. pool, crèche, sauna, gym) and centre.

Safety

- Incidents reports documenting the date, time and nature of each incident, the extent of damage and/or personal injury, and action taken.
- Number of accident free days.

Other society

- Local community involvement (e.g. facilities offered to schools and clubs at discount rates during 'off-peak' times).
- Range of facilities offered specifically to pensioners, mothers and babies, disabled patrons, etc.
- Participation in the wider community (e.g. providing facilities to support sponsored charity events).

Environment

- Number of instances of non-compliance with legislation/regulations (e.g. on chemical spills).
- Energy efficiency (e.g. in maintaining pool at a given temperature throughout the year).
- Incentives for environmental friendliness such as discouraging use of cars/promoting use of bicycles (e.g. by providing secure lock-ups for cycles and restricted car parking facilities). Evidence

Tutorial note: *As there is a wide range of measures of operational performance which candidates could suggest, there is always a wide range of possible sources of audit evidence. As the same evidence may contribute to providing assurance on more than one measure they are not tabulated here, to avoid duplication. However, candidates may justifiably adopt a tabular layout.*

- Membership registers clearly distinguishing between new and renewed members, also showing lapsed memberships.
- Pool/gym timetables – showing sessions set aside for 'over 60s', 'ladies only', schools, clubs, special events, etc.
- Staff training courses and costs.
- Staff timesheets – showing arrival/departure times and adherence to staff rotas.
- Documents supporting additions to/deletions from payroll standing data (e.g. new joiner/leaver notifications).
- Engineer's inspection reports – confirming gym equipment, etc is in satisfactory working order. Also, engineer and safety check manuals and the maintenance program.
- Levels of expenditure on repairs and maintenance.
- Energy saving equipment/measures (e.g. insulated pool covering).
- Safety drill reports (e.g. alarm tests, pool evacuations).
- Accident report register – showing date, nature of incident, personal injury sustained (if any), action taken (e.g. emergency services called in).
- Any penalties/fines imposed by the local authorities and the reasons for them.
- Copies of reports of local authority investigations.
- The frequency and nature of insurance claims (e.g. to settle claims of injury to members and/or staff).

QUESTION TWO

Taurus Traders

(a) Principal Business Risks

Growth

The proposed expansion and diversification increase business risk, in particular:

- Builders' merchants may prove unsatisfactory (e.g. DIY (Do It Yourself) superstores may provide a more suitable outlet).
- The overseas operation increase foreign currency exchange transactions risk
- Overtrading is already contributing to a cash flow crisis
- Product quality is deteriorating perhaps through cheaper supplies being sought
  - New loan fiancé will increase gearing risk
  - Investment is needed in management/accounting personnel and IT systems (see below)

Cash flow

Cash flows are not being adequately managed to meet the company's obligations and liquidity risk is high.
The current cash flow crisis may have serious implications and repercussions, for example,

- Penalties and interest may be accruing on payment arrears
- Suppliers may withdraw their credit facilities
- The bank may refuse further finance including the Shs.2m loan
- Penalties may be incurred if the building work does not go ahead as contracted for
- Poor debt collection procedures (e.g. large receipt not due for at least another month) increase the risk of bad debts
- 'Rolling over' bills of exchange on overseas purchases may incur supplementary interest premiums.

Faulty materials

Faulty materials indicate increased business risk because:

- A reduction in quality may be underlying cause
- Customer goodwill may be lost
- A substantial accrual may be required for post year end credit notes, in respect of returns
- Materials returned to inventory may have net realizable value less then cost and therefore require wiring down
- Contingent liabilities may arise if faulty materials, being 'specialist' result in faulty building works/constructions
- Subsequent cash sale may facilitate irregularities (i.e. misappropriation of cash receipts).

Chief executive

The company operates under the dominant influence of Mr. Aquila, who is also the majority shareholder. As a result:

- He is in a position to abuse his authority (e.g. committing the company to the building contract without consultation)
  - The organization structure is inadequate (especially when Mr. Aquila is absent)
  - Errors may be made by the accountant (he may not have the resources and training to fulfill the tasks assigned to him).
  - Errors arising may go undetected (because supervision is inadequate)

- The company is exposed to management bias.

The risk of management bias is particularly high because:

- Mr. Aquila is in a position to influence financial reporting
- Shs. 2m loan finance is being sought
- There is a desire to meet profit forecasts
- Shs. 52,000 loan account is to be repaid
- Mr. Aquila's remuneration package may be dependent on results

Financial information/Information technology

The annual budget and management accounts are not sufficiently accurate to provide information for decision-making purposes. The discrepancies on the control accounts could indicate that proper accounting records have not been kept. Errors may also arise in the computerized system. It is possible that the bespoke software is not adequate for Tauru's needs (e.g. if the choice of software writer was based on the family relationship rather than his technical competence or relevant experience). The financial and accounting systems which is required to produce a profit forecast for the bank and financial statements for audit, may be deficient.

IT currently employed does not adequately support current needs (foreign currency purchase) and will require upgrading to meet future needs (recording transactions of overseas operations).

Going concern

There are doubts about the company's ability to continue as a going concern because it is dependent on:

- Mr. Aquila's personal involvement in the negotiations of transactions
- Increased overdraft facilities
- New, Shs. 2m, loan finance
- Resolution of the faulty material problem
- Debt collection being improved
- Relevant, reliable and accurate information being available to Mr. Aquila for decision-making purposes.

(b) Factors affecting decision to accept engagement

Tutorial note

A list of rote-learned factors applicable to ANY appointment is not going to score as highly as an answer which SELECT those factors which are relevant to THIS appointment.

Current auditors

The current auditors are likely to be removed (or not re-appointed) by Mr. Aquila, as majority shareholder, in the near future. Any 'statement of circumstances' (or similar), to be deposited with the registrar, may indicate that the proposed appointments should not be considered further. If Mr. Aquila does not give permission for communication with the current auditors, proposals should not be pursued.

Audit qualifications

It is possible, or even probable, that the current year audit report should be modified on the issue of going concern and/or limitation on scope (e.g. if proper accounting records have not been kept.) Mr. Aquila may be 'opinion shopping' because a qualification is likely to jeopardize the granting of new loan finance.

Financial advice and other services

As the company is not in a fit state to be floated on a stock exchange, it will be some time before such services as those of reporting accountants are required. However, opportunities for management consultancy, IT bad taxation advice are apparent. Also, the current auditors prepare the annual financial statements – a service which is likely to be required by the company's auditor until Taurus traders has its own accounting expertise.

Fee recoverability

It is possible that the current auditor's fees are outstanding along with tax liability arrears. Mr. Aquila may offer his personal guarantee but the current demands of his domestic affairs would make it worthless.

Audit Strategy

An appropriate audit strategy for the first audit will involve detailed substantive testing of transactions and balances.

Justification

High inherent and control risks (see below) render detection risk low. Because of the lack of prior knowledge, analytical procedures may have limited application (and non-sampling risk may exist).

As error incidence may be high, large samples must be planned to keep sampling risk low. In particular, the intolerance of monetary unit sampling to errors may necessitate more sophisticated, computer-assisted, methods being adopted.

Inherent risk

In addition to the business risks there are also the risks arising from our lack of prior knowledge. Although a lot of information will have been obtained in connection with the proposal we will, for example, have little knowledge of error incidence in the accounting systems.

Control risk

Control risk in all accounting areas is high because:

- The chief executive has sole, overall control
- There is a lack of segregation of duties
- Accounting personnel are insufficiently qualified
- Computer software may be inadequately maintained
- Important accounting controls e.g. control account reconciliation, are absent.

Revenue/receivables

There is a risk of overstated because, for example:
- Management requires high profits
- The receivables' ledger control account is not reconciled
- Credit notes for faulty materials may not be accrued
- Provisions for bad and doubtful debts may be inadequate
- Cash sales of faulty materials may be unrecorded

The approach to verifying year-end trade receivables and allowances will therefore incorporate direct confirmation and detailed substantive testing of after date cash and credit notes.

Some use of analytical procedures to confirm the completeness of recorded income may be possible although the reasons for variations in profit margins must be substantiated.

Purchase/payables
There is a risk of understated because, for example:
- Management requires high profits
- The payables ledger control account is not reconciled
- Interest and penalties on tax arrears, overuse bills of exchange and overdraft excesses may not be accrued
- Supplies invoices may be suppressed
- Provisions may be required for redundancy payments, liquidations fees etc, if the company ceases to be a going concern.

A substantive approach to the verification of year-end liabilities may include requesting direct confirmations from suppliers as well as detailed testing of foreign exchange transactions calculations.

Inventory

Inventory may be overstated because, for example;
- Management wish to report high profits
- Unidentified faulty materials may not be written down
- Faulty materials returned may not be adequately provided against
- The inventory accounting system is likely to e inadequate
- Inventory held by third parties (e.g. builders' merchants) may include a profit loading.

Detailed substantive testing of year-end inventory will include attendance at physical inventory counting and verification of its valuation.

(d) Procedures to improve accounting procedures and financial controls

Budgets and management accounts

Formal budgets setting procedure and the preparation of monthly management accounts should be established for forecasting and variance analysis. To cope with the uncertainty, which will surround continued growth and expansion a system of rolling budget might be appropriate.

Control account reconciliation's

The reasons for differences on the receivables and payables control accounts should be identifies and resolved. (For example, it is possible that the differences on the payables control account

are related to foreign exchange translation calculations). The control accounts must then be reconciled monthly. This will be a pre-requisite to improving cash flows.

Debt collection

Credit control must be improved to ease the cash flow crisis and reduce the need to provide for bad and doubtful debts. Specialists assistance in the form of debt factoring may be advisable. Incentive discounts could be introduced also.

Settlement of accounts payable

Credit terms should be negotiated with suppliers and adhered to. It may be advantageous to accept prompt payment discounts through this may require pre-negotiations of the bank overdraft facility.

QUESTION THREE

TUTORIAL NOTES:

Service calls when a customer machine starts to bring problems like producing bad copies the customer will contact the service department of Image Ltd. The receptionist at the service department will take down the customer details, mode of the machine ascertaining from him whether or not its billable or rental and a brief description of what would appear to be the problem with the machine.

The details would then be recorded in a register or a form e.g a request for service form. The receptionist will pass on the details to the head of department who ill identify the technician with appropriate experience of services to that particular machine.

The technician would be dispatched to the customer. and would examine the machine with view to diagnosing the problem with the machine. He would set out parts to be serviced, parts needing replacement and amount of time to be taken when servicing.

If it is a billable machine, he will discuss with the management of the customer giving them an estimate of what it would cost. If the customer decided they want the service to proceed when they would either raise a purchase order and sign or stamp the appropriate spaces on the diagnose form.

If it is a rental machine, the discussion would not take place with the customer rather it would be with the head of the rental machines who would give a go ahead for servicing.

When authorization rakes place the technician concerned then raises a material requisition note for the parts that need to be replaced. He will return to the head of the service department who will consult credit control to confirm that the customer is credit worthy and he will approve the material requisition for the technician to proceed to the stores to be given the parts. The stores will also raise an issue note for the materials which the technician will sign acknowledging he has taken those parts. The technician will then proceed to the customers premises, service the machine and enter the details of the parts used, time taken on a preprinted pre-numbered job card.

When the machine has been serviced and its now functional, the customer will sign on the job card that he is satisfied with the service.
NB: When the service is completed as described above a service call has been made.

CUSTOMER NAME: _____ NUMBER

CUSTOMER ACCOUNT NO. _____

DATE OF SERVICE

0	4	0	1	0	3

INITIALS/PAYROLL NO.

TECHNICIAN

TIME TAKEN

0	5	2	5

JOB CARD NO.

MATERIALS USED

CODE NO.	DESCRIPTION	QUANTITY
_____	_____	_____
_____	_____	_____

SERIAL NO.

SIGNATURE _____

SERVICE ENGINEER

- Data fields are the headings for which date is to be filled in appropriate spaces.
- The files are:
  (i) Transaction file
  (ii) Rental contract master file
  (iii) Customer master file
  (iv) Stock master file
  (v) Sources rendered price master file
  (vi) Returned used parts master file
  (vii) Personnel master file

Possible errors and irregularities

1. Some dockets may be misplaces and therefore never reach the computer room. This can be deliberate or inadvertence.
2. The technician may fail to put appropriate data in the data fields or enter data wrongly in the data fields.

3. A combination of errors regarding customer details e.g. the correct customer name, correct account number but the serial number is not of the machine as the customer premises.
4. A combination of errors regarding the stocks of the path used e.g. a technician may never have returned the replaced parts, the code number may never match the description, the quantity on the docket may be different to the amount released for that machine, the docket may include parts never released, it may exclude parts released for that machine.
5. The technician could indicate more or less time than he actually spent at the customers premises. Besides the customer could be over or under charged for labour.
6. The service engineer could wrongly mark a billable machine as a rental machine and vice versa.
7. The technician though having a job card may fail to raise a docket or may attempt to use the same job card to raise more than one docket. These are problems of omission and duplication.

(The above foregoing is tutorial guidance and is not required for answering this question. It shows the conceptual process before producing the answer below)

(a) The main steps that I would expect to be executed by means of a computer program to identify and report service call billing errors by Image Ltd.

1. There is a possibility of an error of completeness whereby some dockets can be misplaced between their preparation by the technician, validation by the service engineer and data capture by computer room. By pre-numbering you establish a control. I would therefore expect the system to check the serial number and report any missing numbers for investigations.
2. During the process of transcribing details from the job card into the docket the technician may fail to fill in the relevant data fields or fill wrongly in the appropriate data fields.

   Therefore I would expect the program to execute:
   (a) A missing field check to ensure that all the missing data fields like data of service time taken, materials used and the serial number of unit prepared are present and are of the right length as transactions cannot be properly processed if necessary data is missing.
   (b) A valid character check to ensure that the data fields appears to be of the right type e.g. the date of service should be all numeric, the materials used should be mixed, time taken should be all numeric. This is to ensure data fields appear to be correct.
3. The details regarding the customer should be consistent i.e. the customers name is given, then the account number given must be of that customer in the customers master file and the serial number on the docket must be the serial number that belongs to that customer.

   As a combination of errors can occur regarding these details e.g. wrong serial number or account number, I would expect the program to execute a master file check of the customer details as per the dockets to the customers master file.
4. The details regarding the parts used include the code number for the par, a verbal description of the [art and the quantity used on the job. It is possible that the technician can make errors in filling in the data fields. Therefore I would expect the program to:
   (a) Execute a master file check against the service parts master file to ensure that the code number given and the description given are for a part on that master file and that the quantity was the quantity released for that machine.
   (b) Execute a master file check against the returned used parts master file to detect whether the technician had returned a similar part after providing the service.
   (c) Execute a check digit to the code number and matching the code number to the description to detect keystroke errors in the code number and the description.
5. The technician could indicate more or less hours than actually spent at the customers premises. Consequently a customer may be overcharged or undercharged. Therefore I would expect the program to execute a limit or reasonableness check against the

standard established for the different possible combination of services as per the service rendered price master file.

6. The service engineer manually checks the dockets details against the rental contract master file print out. As a result of this he indicates on the docket whether the machine is billable or rental. He could wrongly indicate a billable machine as a rental machine and vice versa. Therefore I expect the program to execute a master file check at the serial number on the docket against the computerized rental controls master files ensuring that if the serial number given is not on that rental contract master file then automatically this would be a billable machine.
7. Dockets may not be raised for some job cards a job cards may be used to prepare more than one docket. I would expect the program to execute the following steps:
   (a) Undertake a sequence checks on the job card numbers to detect incidences of duplication of job card m numbers and to report gaps in numerical continuity of job card numbers.
   (b) To execute a matching routine matching job cards to dockets ensuring for every job card there is a docket and vice versa.
8. I would expect the program to execute a reasonable test on the job service against date on job card to ensure the dates are the same and the transactions will be reported in the correct accounting period when it took place.
9. I would expect to execute a reasonableness check on the data of service on the docket and the date the materials were released as per the stocks master file and print pout an exception where the party details have not been reflected on a docket and particularly if they are long outstanding.

(b) Principles of system development stipulate that when changes are applied to systems similar requirements would apply as new systems. Therefore if new consideration is given to review, testing and approval of new systems it should be noted that the basic principles of the controls are that:
   (i) Systems design should include representatives of computer department, user Departments and internal audit as well as the accounting department.
   (ii) The proposed system would have written specifications that are approved by both the management and users.
   (iii) A systems testing should involve both users and the computer department.
   (iv) The computer manager user department database administrator where appropriate and the appropriate levels of senior management should give final approval to the view system before it is placed in operation and after reviewing the appropriateness and the results of testing.

The appropriate procedures and policies for the review testing and approval of new systems are best analyzed or considered under the stages of systems development. The stages of system development are normally classified as:

(a) Feasibility study
(b) Systems analysis and design
(c) Programming
(d) Programme testing
(e) Parallel running
(f) File conversion and implementation
(g) Monitoring and evaluation

QUESTION FOUR

CAPRI GROUP

(a) 'Support letters'

Tutorial note: *Although there are different types and uses of such letters (e.g. for registering a prospectus), the only reference to them in the p3.1 Syllabus & Study Guide is in the context of group audits.*

Consolidated financial statements are prepared on a going concern basis when a group, as a single entity, is considered to be a going concern. However, the going concern basis may only be appropriate for certain separate legal entities (e.g. subsidiaries) because the parent undertaking (or perhaps a fellow subsidiary) is able and willing to provide support. Many banks routinely require a letter of reassurance from a parent company stating that it would stand behind a subsidiary if the subsidiary were to have problems.

As audit evidence:

- Formal confirmation of the support will be sought in the form of a letter of support or 'comfort letter' confirming the parent company's intention to keep the subsidiary in operational existence (or otherwise meet its obligations as they fall due).
- The letter of support should normally be approved by a board minute of the parent company.
- The ability of the parent to support the company should also be confirmed, for example, by examining the group's cash flow forecast.
- The period of support may be limited (e.g. to one year from the date of the letter or until the date of disposal of the subsidiary). Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where the later repayment of material debts is foreseen.
- The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary.

(b) Matters to be considered

Tutorial note: *In broad terms these include the assessments of materiality, what the draft auditor's report and note disclosures mean, the implications for the consolidated financial statements of the Capri Group and Moltisant's auditor's report thereon.*

Materiality

- Capri (Overseas) constitutes 30·6% of Capri Group's profit before taxation and 20% of the Group's total assets (2001 – 30·9% and 22·1% respectively) and is therefore material to the consolidated financial statements. These percentages would be greater if payments in respect of finance leases were not all expensed and the related assets were recognised in the balance sheet of Capri (Overseas).
- The fair value of assets excluded from the balance sheet represents 12·2% of the total assets of Capri (Overseas) and is therefore material to this subsidiary's financial statements. Kshs.790,000 represents 2·4% of the total assets of the Capri Group and is therefore material also to the consolidated financial statements.

Draft auditor's report

- The meaning of the basis of opinion paragraph (extract) is unclear in the following respects:
  - there is no reference to non-compliance with relevant IASs (IAS 17 'Leases' and IAS 12 'Income Taxes');
  - what 'is in accordance with local taxation regulations' – the treatment of the finance lease payments and/or the non-provision of deferred taxation;

  - Marcel does not expressly state whether or not they concur with the treatments.
- That the opinion paragraph is unqualified implies that Marcel concurs with the accounting treatments. (As the matter is material, at least in relation to the finance leases, Marcel would have to qualify their opinion if they disagreed with it.)
- If Marcel concurs, then the references to the notes (4 and 5) amount to an emphasis of matter. As such it should be presented after the opinion paragraph – to make it quite clear that the audit opinion is not qualified in this respect.
- Whether Marcel's prior year auditor's report was similarly modified.

Capri (Overseas) draft financial statements

- The note disclosures appear inadequate because, for example:
  - it is unclear whether all lease payments relate to finance leases or whether some are operating lease payments (which may have been correctly accounted for);
  - no reference is made to the relevant Standards from which Capri (Overseas) has departed;
  - no reason is given for non-compliance with either IAS (see below);
  - it will be practicable to determine (i.e. calculate) taxable temporary differences except in certain circumstances (e.g. in respect of investments by Capri (Overseas).
- Although unclear, Marcel's basis of opinion paragraph (extract) gives a reason for non-compliance which is not included in the notes. This cannot therefore be an emphasis of matter paragraph if it is 'making good' a lack of disclosure in the financial statements of Capri (Overseas). Tutorial note: *Marks will also be awarded for other relevant comments about fair presentation and compliance with IASs as set out in IAS 1 'Presentation of Financial Statements'.*
- Consistency or otherwise of the treatment/disclosure of finance-leased assets and non-provision for deferred taxation with the previous year – both in the financial statements of Capri (Overseas) and in Marcel's auditor's report thereon. If the same situation arose in the prior year, Marcel's current year report should draw attention to the fact that this was previously reported.

Implications for consolidated financial statements and Moltisant's auditor's report thereon

- As Capri (Overseas) is a subsidiary it is, by definition, controlled by the Capri Group and the management of Capri (Overseas) can be told to adjust the subsidiary's financial statements (at least for consolidation purposes). In this case Marcel's' auditor's report should be redrafted as unmodified and Moltisant's auditor's report would similarly be unmodified (in this respect).
- Alternatively, an adjustment can be made on consolidation of the Capri Group's consolidated financial statements. Moltisant's auditor's report would then be unmodified.
- If no adjustment is made in either the subsidiary's or the consolidated financial statements, Moltisant's auditor's report should be qualified 'except for' non-compliance with IASs 12 and 17. The effect of non-compliance with IAS 12 should be quantified.
- The consolidated financial statements should not (usually) refer to the financial statements of Capri (Overseas) being audited by another auditor.

Tutorial note: *In some jurisdictions a principal auditor is permitted to base the audit opinion on the financial statements taken as a whole* solely *upon the report of another auditor, in which case such disclosure should be made and the magnitude of the portion of the financial statements audited by the other auditor indicated.*

QUESTION FIVE

The OECD (Organization for Economic Cooperation and Development) and World Bank are actively involved in initiatives to promote corporate governance practices (e.g. holding an annual forum on the subject). In 1999, the OECD issued a set of Corporate Governance principles which, although non binding, reflect the concepts of:

- The rights of shareholders
- The equitable treatment of stakeholders
- The role of stakeholders
- Disclosure and transparency; and
- Board responsibilities

These principles are now being promoted as framework for dialogue and consultation with emerging and transition economies with the aim of improving corporate governance practices.

Further in June 2000 OECD issued governance guidelines for multinationals that provide voluntary principles and standards for responsible business consistent with applicable laws. The International Forum on Accountancy Development (IFAD) is an initiative of IFAC and the World Bank. Its vision is to achieve a rational framework of reporting on the performance of economic entities, which serves the objectives of issuers and users across the world. This vision calls for *inter alia*, improving corporate governance practices using the OECD principles of corporate governance as a point of reference.

Needs for IASs

The need for a uniform set of international accounting standards to provide for the transparency and consistency of financial reporting is evident in that IOSCO (the international organization of securities commissions) endorsed 30 International Accounting Standards for cross border listings.

Although these are not (yet) global standards, it is envisaged that IASs will become the international (i.e. global) standards and will not require reconciliation to US GAAP.

Needs for ISAs

The auditing profession plays a key role in both national and international regulation and the development to transparent international standards on auditing (ISAs) provides a high level of assurance on the reliability of financial reporting.

ISAs and International Auditing Practice Statements (IAPSs) have been formulated by IFAC through its international auditing practices committee (IAPC). A significant number of IFAC members use the ISA as a basis for developing their own national standard. IAPC is now working with IOSCO for endorsement of ISAs.

Need for corporate governance standards

Corporate governance may be defined as the ethical corporate behavior by directors or others charged with governance in the creation of wealth for all stakeholders. It is about how these persons:

- Provide stewardship over the business of an entity to achieve corporate objectives:
- Balance the corporate objectives with the expectations of society; and
- Provide accountability to stakeholders.

The need for governance has increased as primary stakeholders have become more removed from management and the control of the entities they own. The use of outside directors in governance roles has been shown to provide protection to entity stakeholders. The growth of global capital markets and the significant frauds which are being perpetrated in these markets has put this need on a global scale. Corporate governance can counter financial statement fraud, corruption and money laundering.

If investors are to invest, stamping out corruption (for example) is important. An infrastructure is therefore needed for regulation, corporate governance disclosure and transparency.

The importance of the role of corporate governance is reflected in the IAPCs ISA 260. Auditors are required to communicate audit matters of governance interest to those charged with corporate governance on a timely basis. That the ISA requires the auditor to identify those responsible for governance, when the entity has not, emphasizes the need for governance systems to be established.

It has widely been reported that had corporate governance and public governance existed in Southeast Asia, then the economic crises that occurred in 1997 may have been avoided (because the speculators would not have such a free hand as they did).

Arguments for global corporate governance standards

Corporate governance on a national basis is appropriate when investing and financing by companies is on a national basis. However, a set of global rules should be applicable, as a minimum, to entities listing shares or obtaining financing in the public capital markets outside of their national boundaries.
Requiring companies who participate in global capital markets to follow global rules will provide greater protection to global investors. Corporate governance will still be required at a national level.
The use of Global Shares by global business enterprises increases the need for corporate governance rules to be global. Global shares (i.e. the same form of shares for listing in a home country and a non home country) enable virtually seamless cross border trading. As their use becomes more widespread, global stakeholders will need higher quality global accounting, auditing and corporate governance standards.

Regulators are national, not international, so international consistency is needed to avoid regulation arbitrage. Global standards are necessary because national and international standards will not converge of their own voliation. Local subsidiaries of international groups tend to be content (e.g. on cost grounds) to comply with lower local standards (e.g. accounting and auditing) and not adopt the higher standards of their parent's location.

Companies in some countries (e.g. in India) have been advised not to globalize until there is a framework for good corporate governance. It is therefore asserted that global standards are key to developing countries' prospects for substainbly mobilizing capital for economic growth. Developing countries can further benefit by imitating the models and systems of another – rather than incurring the costs of developing their own models.

There does not have to be a "one size fits all" approach to global standard because there are universally recognized standards that can provide benchmarks (e.g. responsibility, accountability, fairness and transparency). If universal principles of transparency and objectivity (for example) can support international accounting and auditing frameworks, then a global corporate governance model can cater for different legal structures and cultural identities.

OECDs voluntary code provides a point of reference for multinationals, which are encouraged to:

- Contribute to economic, social and environmental progress
- Respect the human rights of those affected by their activities
- Encourage local capacity building
- Encourage human capital formation (e.g. by creating employment opportunities and through training programs)
- Refrain from seeking/accepting exemption from environmental, health and safety, equal opportunities and labor legislation, etc
- Support and uphold good corporate governance (principles and practices)

- Abstain from improper involvement in local political activities

Arguments against global corporate governance standards

Development of corporate governance and its implementation needs to be at a national level because regulators are national and it is not appropriate, given the need to respect diverse cultures and legal structures, to prescribe a global standard. For example:

- Concern in the US is for increasing shareholders value
- Continental Europe's economic philosophy is creating employment
- In Japan companies work with the government towards the national strategy

Many people fear that global corporate governance standards may attempt to impose an Anglo American business model on developing countries. Corporate governance and the composition of boards should suit the local business environment to encourage economic success.

IAPC has established as a principle that auditors determine the relevant persons who are charged with governance responsibilities. However, that there may be no such persons suggests that the needed for governance is not yet proven at a national level.

Global standards are necessary because they emerge eventually by a natural process of convergence. For example, International Financial Reporting Standards (IFRSs) have been issued by the international Accounting standards board in place of separate international accounting standards (IASs) and UK Financial Reporting Standards (FRSs) since the end of 2001

International standards are not global standards. If accounting and auditing standards have only reached an international level then the need for corporate governance standards at the present time is only international – not global.

Conclusion

A global corporate governance framework is essential for high quality financial reporting and auditing standards to be interpreted, used and enforced consistently throughout the world.

Alternatively

Accounting standards have been implemented on a nation-by-nation basis before the international acceptance by IOSCO of international accounting standards. Auditing standards are following suit. The OECD principles are very general and as the need for global corporate governance standards is apparent, the initiatives to create them will continue to emerge.

MOCK TWO

QUESTION ONE

Abacus Leasing

It should be apparent to a prospective auditor that the audit of Abacus Leasing ltd is a high-risk audit and therefore the quality control procedures to be adopted before tendering for such an audit would include:

i. A request to communicate with the previous auditor. A refusal of this would inevitably lead to a refusal by the auditor to tender.
ii. The previous auditor should be asked if there are any circumstances of which they are aware that would have a bearing on the prospective auditors willingness to tender. In particular, details of the reason for their resignation would be relevant.
iii. A visit to the firm to make a preliminary assessment of the audit risk with particular attention being focused on the systems of controls and activities of the company.
iv. Determine whether your firm has the expertise, experience and capacity to undertake the audit (leasing building equipment does not appear to be a very specialized business)
v. A commercial assessment must be made. The prospective client appears to have weak controls and several high-risk areas. This may entail a large amount of audit time making the audit fee expensive. The financial position of the client may not be sound and there may be a serious risk of non-payment of the audit fee. The risk of an incorrect audit opinion being given increases the possibility of legal action against the auditor as well as the possibility of bad publicity and implications for future insurance indemnity premiums.

(b) The following factors would need to be considered in assessing the level of the inherent risk in Abacus Leasing Ltd.

i. The suspicious circumstances in which the previous auditors resigned particularly the reasons for the audit qualification. It would appear that there are poor internal controls at Abacus Leasing Ltd, and further, it seems management are reluctant to improve them.
ii. The domination by the managing director.
iii. The company is a 'new' company with little history and the growth of the company is spectacular.
iv. There may be an element of overtrading causing the company to be over borrowed, highly geared and experiencing liquidity problems.
v. The bonus incentive for management may have caused high-risk sales (leases) to have been made or the turnover figure may have been falsified.
vi. The nature of the products, building equipment, can have high associated risks. There is frequent theft of this type of equipment and as the equipment is often abused in its use it may not last the length of the lease making default more likely.
vii. The high proportion of assets in the form of debtors which appear to be difficult to collect and the lack of a formal system of collection.

(c)

(i) The principal aim is to determine whether a lease fails to be treated as a finance lease or as an operating lease. It may also be possible that some agreements are not leases at all. If they contain an 'option of purchase' that is likely to be exercised they should be treated as hire purchase agreements although such treatment is in substance similar to a finance lease.

IAS 17 Leases says that a finance lease transfers substantially all the risks and rewards of ownership to the lesser. This is deemed to occur when the present value of the minimum lease payments amounts to substantially all (normally taken as 90% or more) of the fair value of the asset.

Therefore the auditor must perform the following work.

i. Obtain and inspect copies of the different types of lease agreements.
ii. Determine the fair value of the asset. In practical terms this will be the purchase price, but it would be net of any trade or large quantity discounts and any grant assistance for the purchase. The auditor must identity the specific asset being leased in the agreements and determine its original cost by tracing the purchase invoice and the payment made. If any grants have been received by Abacus Leasing ltd during the year, the documentation relating to them must be inspected to determine which assets had grant aid and how much this was.
iii. The minimum lease payments (MLP) should be readily determinable from the agreement. The auditor would then calculate the present value of the MLP using an appropriate discount rate. The discount rate should be confirmed by the management and market interest rates to confirm the appropriateness of the rate.
iv. The results of the above tests should determine whether the agreement is a finance lease or an operating lease (as per the definition above). If it is a finance lease the outstanding net cash investment in the finance lease should be shown in debtors. The rental income should be allocated partly to finance charges and credited to the profit and loss account; the balance being a repayment of the lease debtor. If it is an operating lease the assets should be shown under fixed assets and depreciated over their estimated lives, with the rental income credited to the profit and loss account.
v. If a lease has been incorrectly classified there may not be a material error in the total value of the assets on the balance sheet. However it could lead to an incorrectly presented balance sheet.

(ii) The work the auditor would do to confirm the estimate of the bad debts provision is:

1. Confirm the gross debtor by the tests above and, using an appropriate sample, perform a positive debtors circularization.
2. The auditor should focus his attention on recent debtors, as these are likely to be of greater value and at more risk of non-payment. Leased debtors differ from normal trade debtors in that they are not receivable within a short period of time. The auditor should check to see if any debtors contain overdue installments. Such debtors are more likely to be bad. Some of the lessees may be in dispute and the payments have been stopped. This should be investigated by the auditor.
3. The auditor should review the company's procedures for recovery of debtors which have breached the terms of the agreements. As these are known to be weak further substantive testing should be performed to confirm the value of the debtor balances.
4. The above tests should give the auditor a basis for estimating the gross provision required for bad debts. From the information in the question this is likely to be a high figure due to the credit standing of some of the debtors and the sales policy encouraged by the bonus scheme.

Lease debtors again differ from most trade debtors in that Abacus Leasing ltd retains ownership of the related assets. Where an agreement is in default such assets may be repossessed by the company.

If Abacus Leasing ltd has reduced the gross provision by an estimate of the recoverable amount of leased assets the auditor must do further work. The auditor should try to obtain proof of the physical existence of the assets to confirm they are still in the possession of the lessee and to determine their condition. This may be very difficult in practice. The auditor would then form an opinion of the recoverable amount of the assets. This would either be an estimate of the their net selling price or their fair value if leased to another builder. The value to be used would be dependent upon the intention of management and the auditor agreeing its appropriateness.

QUESTION TWO

Midland Builders

(a) IAS 10 (revised) Events after the Balance Sheet Date deals with events which occur between the date of the balance sheet and the date the accounts are drawn up. The events may need to be incorporated in the financial statements. Those that do are called adjusting events (they provide additional information on the conditions existing at the balance sheet date) and those events which do not affect the position at the date of the balance sheet non-adjusting events which may require to be referred to as note to the financial statements (unless it affects the company as a going concerning).
The director's view is therefore incorrect. If the events provide additional information on the conditions existing at the year end then an adjustment should be made.

(b) Several are possible from the following list

- Identifying items at the balance sheet date which may be susceptible to later confirmation.
- Enquiring into management's procedures for dealing with post balance sheet events.
- Reviewing accounting records and cash flows
- Reviewing client's internal management reports including budget reports and interim accounts.
- Reading minutes etc
- Reading external documents which may have an impact.

(c) (i) Refusal of planning permission

Check the facts i.e. original cost, examine correspondence with planning authority, review estimates of net realizable value by reference to external valuer's certificates etc.

The decline in value occurred only on refusal of planning permission. The land is worth at least cost until then and hence this is non-adjusting.

Alternatively, the original value (cost) might have incorporated information that planning permission would be obtained. Subsequent events cast new light on that assumption and are thus adjusting. The correct treatment is therefore to adjust.

(ii) Completion of long term contract

Check all facts e.g. costs to accounting date and to completion work certified to accounting date and to completion, cash paid. Consider retentions and possible guarantee work. Examine contract and all papers connected with the contract including the costing. Check calculations for accounting treatment.

This is clearly an adjusting event as it gives evidence on conditions existing at the balance sheet date.

(iii) Liquidation of trade investment

Verify facts and opinions by examining share certificates, share quotation, correspondence and accounts from liquidator.

It is clear that the asset had a value at the balance sheet date as it was quoted. However it seems that at that time the real value of the company was nil and it therefore should be valued at nil in the balance sheet.

QUESTION THREE

FARRINGTON

Audit program heads (with purpose in brackets)

(a) Trade creditors:

- Obtain schedule (this is the sum to be audited)
- Examine previous year schedule (for analytical review)
- Carry out analytical review (compare with monthly purchases and previous years' ration for reasonableness, to identify situations requiring further study)
- Determine, record evaluate and test internal control system (always necessary if any reliance is to be placed on internal controls, for example for completeness evaluation)
- Cut off testing (the major source of error, to be carried pit in conjunction with other areas e.g. stocks and sales)
- Control account agreement (clearly if this does not balance then the creditors may not be correct)
- Examination of individual balances (also to verify accuracy of processing)
- Examine suppliers statements (to check balances with external evidence)
- Possibly circularize creditors (to obtain true independent third party evidence)
- Examine post balance sheet events (to determine if all creditors are included).

(b) Sundry accruals

- Obtain schedule (this is to be audited)
- Obtain schedule of previous year (for comparison)
- Analytical review (to see if last years items have this year items also and also to see that expected items are present.
- Substantiate each item (to ensure correct amount is included)
- Examine post balance sheet events (to ensure all items are included)

(c) Provisions

- Examine all provisions (are they needed?, is the amount too large merely to reduce profits?, are they too little to avoid reducing profit?
- Examine directors minutes, post balance sheet events, correspondence with lawyers etc for evidence of the need for provisions (essential to ensure all necessary provisions are included)
- Consider SSAP 18 requirements (to ensure true and fair view is given)
- Legal action: examine correspondence with lawyers, read directors minutes, discuss with management, consider probabilities of payment with requirements of SSAP18, perhaps obtain letter from the lawyer.
- Factory repairs; review initial needs and the evidence of disrepair then presented and evaluated, verify and inspect the repairs costing Kshs.58,000 examine estimates and quotations and reports from builders, architects, surveyors etc examine directors minutes and discuss with management.
    - Review with any evidence available (minutes, correspondence, registers, registration documents with government agencies etc) possibility of liabilities arising out of pollution or health or and safety legislation.

QUESTION FOUR

(a) Auditors would be unlikely to use audit sampling techniques where;

i. Populations are too small so that statistical theory cannot be applied without creating unacceptable margins of error.

ii. There are balances or transactions which are of great significance in terms of size, but few in number and
iii. Populations are unsuitable because they are non homogenous which means that sorting is required before sampling can take place.

(b) (i) Attribute sampling is concerned with sampling units, which can only take one of two possible values (say 0 or 1). It can thus be used to measure what proportion of items in a population have a particular property and what proportion of items do not have that property. It does not deal with monetary amounts and it is now primarily used in tests of control.

Each occurrence of or deviation from, a prescribed control procedure is given equal weight in the evaluation of the results, regardless of the monetary amount of the transaction.

The sample size is calculated as:

Reliability Factor

Precision level

The reliability factor taken from tables is associated with the level of assurance the auditors want or need to obtain from the test. The precision level is the number of errors the auditors are willing to accept in a population to be assured that the population is correct.

(iii) Monetary unit sampling (MUS) has two main characteristics, items are selected testing by weighting. Items are selected for testing in proportion to their value, and inferences are drawn based on attribute concepts.

MUS produces conclusions based on monetary amounts, not occurrence rates, by defining each Sh1 of a population as separate sampling unit. Thus a purchase ledger of $3.6m sampling units.

The sample size is defined as

Reliability factor x population value

Tolerable error

The sampling interval is then calculated as

Population value

Sample size

Hence given a sample size of Kshs. x, the auditors will then select every x sampling unit in the population, starting from zero and added cumulatively (0, x, 2x) starting from a random point in the population. The quantified errors found can easily be extrapolated to the whole population.

One of the advantages of MUS is that all items larger than the sampling interval will be selected. This selection of larger item gives a weighting, which makes the reduction in the sample size acceptable.

(c) The factors which the auditors should consider when determining the size of a sample as follows.

1) **Assurance provided**. The auditors have to accept a risk (sampling risk) that they may reach a different conclusion by sampling than they would if they examined the entire population. The degree of assurance the auditors plan to obtain from the results of the sample has a direct effect on the sample size. The greater the degree of assurance required, the larger will be the required sample size.
2) **Tolerable error/deviation rate**. This is the maximum error or deviation rate the auditors are prepared to accept in the population and still conclude that their audit objective has been achieved. The larger the tolerable error or deviation rate, the smaller need to be the sample size.
3) **Expected error/deviation rate**. If the auditors expect errors or deviations to be present before performing tests, for example because of the results of the previous years tests or their evaluation of internal controls they will need to take this into account in selecting an efficient sampling method and determining the sample size.

4) **Stratification**. This is the process of dividing a population into a sub population so that items within each sub population are expected to have similar

characteristics in certain respects. This reduces the degree of variation between items. By stratifying, the auditors can devote more of their attention to those items considered most vulnerable to material error.

(d) Statistical sampling enhances the quality of the audit evidence for the following reasons.

i. It imposes on the auditors a more formal discipline as regards planning the audit of a population in that they cannot perform the mechanics of selecting a statistical sample until they have decided on the tolerable error in respect of the population and the amount of audit assurance that they wish to obtain from the sample.
ii. The required sample size is determined objectively. Once the auditors have used their judgment to decide the tolerable error and the level of assurance required, the statistical method determines the sample size required to satisfy their objectives.
iii. The evaluation of test results is made more precisely and the sampling risk is quantified.

QUESTION FIVE

(a) 1. The weakness in the cash system are as follows:

i. The physical location of the dispatch department and the cashier are not mentioned here, but there is a risk of the customer taking the goods without paying. The customer should pay the cashier on the advice note and return for the goods, which should only be released on sight of the paid invoice.
ii. There is a failure in segregation of duties in allowing the cashier to both complete the sales invoice and receive the cash as he could perpetrate a fraud by placing the original invoice with one of lower value and keeping the difference.
iii. No one checks the invoices to make sure that the cashier has completed them correctly, for example by using the correct prices and performing calculations correctly.
iv. The completeness of the sequence of sales invoices cannot be checked unless they are pre numbered sequentially and the presence of all the invoices is checked by another person. The advice notes should also be pre numbered sequentially.
v. There is also no check that the cashier banks all cash received, i.e. this is a further failure of segregation of duties.

If the sales department prepared and posted the invoices and also posted the cash for cash sales to a sundry sales account, this would solve some of the internal controls problems mentioned above. In addition, the sales department could run a weekly check on the account to look for invoices for which no cash had been received. These could then be investigated.

All of these weaknesses and possible remedies should be reported to management.

2. After confirming the cash sales system was operating as described (by walk-through test) I would carry out the following tests in order to ensure that there was no material fraud or error in the operation.
   i. Select a sample of advice notes issued to customers during the year. Trace the related sales invoice and check that the details correlate (date, unit amounts etc). The customer should have signed for the goods and this copy should be retained by the dispatch department.
   ii. For the sales invoices discovered in the above test, I would check that the correct advice note number is recorded on the invoice, that the prices used are correct (by reference to the prevailing price list) and that the castings and cross-castings (i.e. arithmetic) is correct.
   iii. I will then trace the value of the sales invoices to the cashbook and from the cashbook that the total receipts for the day have been banked and appear promptly on the bank statement.
   iv. I would check that the sales invoices have been correctly posted to a cash or sundry sales account. For any sales invoices missing from this account (assuming they are sequentially numbered), I will trace the cancelled invoice and check that the cancelled invoice was initialed by the customer and replaced by the next invoice in sequence.
   v. Because of the weakness in the system I would carry out the following sequence checks on large blocks of advice notes/invoices, e.g. four blocks of 100 advice notes/invoices.

      - Check all advice notes present; investigate those missing
      - Check sales invoices raised for all advice notes
      - Check all sales invoices in a sequence have been used; investigate any missing
      - Cash for each sales invoice has been entered into the cashbook.

      Using the results of the above tests I would decide whether the system for cash sales has operated without material fraud or error. If I am not satisfied that it has then I will consider qualifying my audit report on the grounds of limitation of scope.

(b) (i) The control is designed to ensure that all receipts are banked in the company's account.
This presence of two employees when mail is opened makes it unlikely that there will be theft of receipts, as this would require collusion between them. Compilation of a list of receipts provides an agreed record, which can be used as a check that receipts are not misappropriated before they are banked.
Neither of these people should be the cashier as this too would be a breakdown of internal control in terms of segregation of duties.

(ii) Audit tests on the opening of mail and the subsequent banking of cheques might include the following

   i. Observation (by surprise) of the routine for opening mail and discussion with management and with the staff involved of the way in which it is conducted. In particular, discuss routine in case of staff absence or holidays.
   ii. Select a representative sample of listing of receipts and agree the amounts to the cashbook, paying-in slips and bank statements. Ensure that each days receipts are banked intact and promptly (i.e. that day to the next).
   iii. Check that the banking appears on the bank statements within two working days. If there is any delay I should investigate as a teeming and lading fraud may be taking place.

iv. Compare receipts per listings with other evidence of the amount sent, for example customer remittance advice.
v. Circularize a representative sample of debtors. This will provide evidence, amount other things, that customer receipts are banked intact.
vi. Check the bank reconciliation's performed during the year and ensure there are no long outstanding lodgments or unexplained differences.

(c) (i) Credit notes will be issued for a number of reasons.

i. Goods are returned by customers for a variety of reasons and the credit note reimburses them, canceling all or part of the relevant invoice.
ii. An error of some kind on the customers account requires correction. This could involve posting an invoice to the customer's account, which does not apply, to that customer, etc.
iii. Errors in the calculations on an invoice require correction, e.g., wrong prices charged, VAT errors, errors in arithmetic etc.
iv. Short delivery has been made on an invoice, i.e. the customer has received fewer items than specified on the invoice.
v. Compensation is given to the customer, perhaps because goods were faulty (but they were not returned) or goods were delivered late, etc.

(ii) I would carry out the following audit work to test whether credit notes were authorized and issued for a valid reason.

i. Select a sample of credit notes issued during the year (from the complete sequence of numbers issued) and check authorization and supporting documentation (returns note, correspondence with customer and GRNs copy of invoice marked up for errors, confirmation from the production department that the goods were faulty etc)
ii. Select a further sample of credit notes from customer accounts in the sales ledger and check that they are valid supported by documentation and authorized.
iii. It may be worth checking high value credit notes from during the year as these present an opportunity for fraud. Once again, validity, documentation and authorization should be checked.
iv. Any provision for credit notes at the year should be checked in detail, particularly for high value items, as these present an opportunity for window dressing (i.e. reversing sales which are then put through again after the year end.

Any weakness discovered in the system should be reported to management.

MOCK THREE

QUESTION ONE

Tutorial note: *These model answers are considerably longer and more detailed than would be expected from any candidate in the examination. They should be used as a guide to the form, style and technical standard (but not length) of answer that candidates should aim to achieve. However, these answers may not include all valid points mentioned by a candidate – credit will be given to candidates mentioning such points.*

1 MEADOW

(a) Principal audit risks and other matters

Tutorial notes:

(1) *The requirement to 'identify and explain' suggests that although marks will be awarded for the mere identification of risks etc from the scenario (e.g. 'loss on operations'), those risks must be described (as illustrated below).*

(2) *Other planning matters include materiality, audit approach/strategy to balances and transactions, accounting treatments, etc including practical/logistical issues.*

Risks

- Inherent risk is increased at the entity level as Meadow operates in geographically diverse locations.
- Apart from going concern risks, the reduction in consumer spending may have implications for the valuation of inventory, particularly home furnishings ('luxury' goods).
- Meadow's principal activity is identified with a single brand name. Any damage to the reputation of the Vazandt name in one geographic area (e.g. following the closure of African operations) may affect retail trading elsewhere.
- Inherent risk is increased at the account balance and class of transactions level because, for example, advantage may be taken of 2002 appearing to have been a 'bad year' and certain accounting policies may be overly prudent (e.g. in providing for future trading losses). Conversely, management may be biased to overstating revenue/profit/asset values and understating other expenses and liabilities to conceal the extent of a bad year.
- Inventory may be overstated if net realisable value is less than the carrying amount determined using the retail method if, for example:
  - a greater proportion of clothes became unfashionable during the year;
  - home furnishings are slower-moving; and
  - foods are perishable.

  Under the retail method an appropriate percentage gross profit margin is one which takes account of mark downs below original selling prices.
- Items of inventory are generally of a nature that is prone to theft (i.e. small, portable, easily accessible, etc). Inventory may be overstated if the year-end valuation is based on book quantities which do not represent physical quantities.

Materiality assessment

Based on the draft financial statements, materiality can be (re-)assessed to be approximately $21m ± $5m (say) which lies in the ranges 1/2% – 1% turnover and 1% – 2% total assets.

Tutorial note: *Alternatively, c. $13m at the extremes of the ranges of 1/2% – 1% turnover and 5% – 10% PBT.*

This monetary materiality should be compared with the preliminary materiality (as used for sample selection for interim and year-end audit testing). If monetary materiality is significantly less than previously assessed (e.g. because turnover, profits and assets were expected to rise), detailed testing at the final audit may need to be more extensive than was first planned.

WORKINGS

1/2% – 1% turnover 12·9m – 25·8m

1% – 2% total assets (at least $1,639·8m1) 16·4m – 32·8m
5% – 10% PBT (before deducting provision2) 6·2m – 12·4m
1 The sum of the assets presented in the financial extracts.
2 To base on PBT after the provision (i) would be a distortion (as compared with the prior year) and (ii) assume the charge against profit to be correct.

Final audit strategy
Tutorial note: *It is too late to be considering the overall audit approach since interim and year-end visits have already happened.*

- A risk-based approach (either audit risk or business risk model) should have been adopted in the overall strategy given the need to effectively and efficiently audit an entity whose operations extend to more than 200 locations (stores) across international boundaries.
- The substantive evidence to be obtained during the final audit is likely to rely heavily on analytical procedures because, for example, disaggregated information will be available by store, business unit, geographic region, etc.
- Analytical procedures are likely to be used extensively for substantive purposes given:
  - the uniform nature of operations across Meadow's retail activities;
  - the multiple locations over which it operates;
  - the clearly identified business units.

  Also, the number of stores in each geographic area is only one more or less than the prior year (facilitating comparison with prior year ratios, etc).
- In particular, in the retail industry, the relationship between gross profit and sales revenue may be expected to remain constant (within geographic regions and business units).
- Given the high volume of low value transactions which make up turnover in a retail business, assurance about the completeness of recorded revenue may be obtained by applying known profit margins (as used to apply the retail method of inventory valuation) to independently verified cost of sales (i.e. purchases as adjusted by the movement in year-end inventory).
- Trend analysis (i.e. the comparison of current data with prior periods) may be particularly useful for analysing income (e.g. monthly revenue by store and business unit).

Documentation

- The overall audit plan and audit program should be amended to reflect changes in:
  - materiality assessment;
  - risk assessment (e.g. if inherent risk is higher because operational losses were not expected or control risk is lower because greater reliance can be placed on internal controls);
  - draft financial statements as compared with prior year (see below).

Logistics

- The work of Robert Bracco's affiliated offices will have been co-ordinated (e.g. to ensure that staff were available to visit selected stores at the year end).
- The results of store visits (e.g. to attend physical inventory counting and count cash) should be summarised to identify any stores in particular need of follow-up (e.g. those holding large quantities of slow-moving items).

Draft financial statements

- The reliability of information in the draft financial statements should be assessed, taking into account such factors as Robert Bracco's prior knowledge and experience of:
  - the accuracy with which they are prepared; and
  - the nature of amendments made before the financial statements are finalised.
- In particular, ratio and trend analysis will be less meaningful if period-end adjustments have not yet been made (e.g. charges for depreciation and bad and doubtful debts, inventory write-downs, etc).

Falling turnover

- Turnover has fallen by just 2% overall. The 3% fall in national turnover has been mitigated by the increases in Africa and South America (of 2·4% and 5·4% respectively).
- Analytical procedures on profit margins may not provide sufficient evidence regarding the completeness of recorded income.

Provision for loss on operations

Tutorial note: *There are a number of related matters here – the provision of the loss, the discontinuance of business in Africa,*
and the international restructure. These can be considered collectively, as here, or under separate headings. The audit evidence aspects are described in (b)(ii).

- The provision Kshs.83·8m has reduced operating profit before tax by c. 67% and is therefore material.
- The IAS 35 definition of 'discontinuing operation' must be met if that term is to be used. The definition is met in part as the African operations represent a geographical area that is distinguished operationally and for financial reporting purposes (as evidenced by segment information).
- The presentation and disclosure requirements of IAS 35 will apply to the discontinuing operations in Africa only if the definition criteria are met.
- The announcement made on 29 September (of the intention to close the African operations) will be the initial disclosure event providing the board has approved a detailed formal plan.
- However, the board's decision to restructure does not appear to give rise to constructive obligation because Meadow has not (before the balance sheet date):
  - started to implement the restructuring plan; or
  - raised a valid expectation in those affected that the restructuring will occur (because the decision is dependent on further consultation).
- If a restructuring provision is appropriate it should include only:

– redundancy costs
– contract termination costs
– sundry expenditure incurred in the course of the reorganisation.

A restructuring provision does not include costs for the future conduct of the business such as retraining or relocating
continuing staff (if any).

- A monetary break down of the provision will need to be substantiated and the amount for future operating losses up to
  the date of restructuring adjusted for (unless it is for an onerous contract).
  Non-current assets
- The carrying amounts for land and buildings and store fit out, etc have fallen by Kshs.13·5m (1·4%) and Kshs.32·9m (6·8%)
  respectively. As the number of stores has not changed by more than ± 1 during the year most of this fall may be attributable to annual depreciation.
- Inherent risk in this area may therefore be low except that, in view of the proposed international restructure, further allowance may be needed to reflect possible impairments in the values of African and South American assets. Store fit
  out, fixtures and fittings may be the most significantly impaired in Africa, where the operations are being closed (whereas the South American businesses are to be sold).
  Inventory valuation
- The retail method is often used in this industry because with large numbers of rapidly changing items it is impracticable to use other costing methods.
- The cost of inventory should be determined by reducing the sales value by the appropriate percentage gross margin (IAS 2).
- The percentage used should take into consideration inventory which has been marked down to below its original selling price.

- Average percentages used for each retail department (Ladieswear, Menswear, Home furnishings and Foods) should be comparable with prior years by geographic region.
- The percentages for the African stores may be expected to be greater than the prior year to make further allowance for net realisable value being reduced.
- Trade receivables
- As a retailer, Meadow's trade receivables are immaterial (< 2% of total assets shown in financial extracts) and audit risk will be low in this area.

Segment information
Tutorial notes: *Two examinable documents are relevant here – IAS 14 and ISA 501. Candidates at this level will be expected to have planned their answer sufficiently well to address the audit evidence aspects in part (b)(i).*
Meadow's primary segment reporting format is geographical segments.

- South America meets the 10% total revenue criteria in 2002 and therefore is appropriately identified as a separate reportable segment.
- Africa and the Far East are both more than 10% of the combined result of segments in loss in 2001 and were then appropriately identified as a separate reportable segment. Africa still meets this criterion (100%!) in 2002.
- Although the Far East does not meet either the 10% revenue or combined result criteria it may be judged to be of continuing significance (as it is the only international geographic operation which is not being closed or sold).
- Sale of South American business
- This is referred to only in the draft note 'International restructure'. The financial statements do not appear to be presenting it as a discontinuing operation as at 30 September 2002.
- South American assets must be reviewed for impairment in accordance with IAS 36.
- If an initial disclosure event occurs after 30 September 2002, but before the financial statements are authorised for issue:

– it should be disclosed as a discontinuing operation (IAS 35); and
– any attributable gain or loss should be disclosed if material to users (IAS 10).

(b) Audit work
(i) Segment information
Tutorial note: *The principle is that when segment information is material, sufficient appropriate audit evidence should be obtained that its disclosure is in accordance with the identified financial reporting framework (i.e. IAS 14 Segment Reporting).*

- Agree the geographical segments and the corresponding figures to those reported in the prior year.
- Check the arithmetic accuracy of the disclosure (i.e. cast the totals) and agree the turnover and operating profit totals to the amounts shown on the face of the income statement.
- Agree the make up of segment revenue (less segment expense = segment result) to internal (e.g. management accounting) analyses (or 'consolidation' schedules).
- Test check the make up of the analyses, on a sample basis, to confirm their accuracy.
- Consider the appropriateness of the geographic segments identified for the primary reporting format.
- Similarly agree the secondary information that should be reported for the business segments (Ladieswear, Menswear, Home furnishings and Foods).
- Review the basis on which expenses that arise at the enterprise level (e.g. head office costs) on behalf of segments (if any) are attributed to segments and confirm that it is reasonable (and in agreement with prior year basis).

(ii) International restructuring

- The detailed, formal plan for the discontinuance of the African operations should be obtained and reviewed to confirm the part of the business/principal locations affected. The detailed plan should also provide evidence concerning:

– the location, function, and approximate number of employees who will be compensated for termination of their services;
– the expenditures that will be undertaken; and
– when the plan will be implemented.

- The date of the board minute(s) approving the announcement of the intention to close the African operations and sell the South American operations should be noted.
- Copies of the announcement(s) should be reviewed (e.g. press statements).
- The post balance sheet event review should monitor developments in the situation, up to the date of signing the auditor's report. For example:

– the outcome of consultation with employee representatives;
– implementation of closures (e.g. whether stores have been closed, staff laid off, etc);
– a binding sale agreement for the sale of the South American operations.

QUESTION TWO

(a) The principal controls I would expect to exist in a wages system and their purpose are as follows:

i. Segregation of duties to prevent the possibility of fraud by an individual. The segregation should operate between whose who calculate the wages, those who make up the pay packets and those who record the pay.
ii. Controls to prevent misstatement or misallocation in the books of accounts and consequently the financial statements, i.e. between production, delivery, finance etc.
iii. Controls to ensure wages are paid at the authorized rate for the times actually worked, Key controls would be authorization of payroll and review of time records.
iv. Controls to ensure wages are only paid to valid employees. Again authorization of payroll changes would be a key control.
v. Controls to ensure that deductions from employees pay are calculated accurately and have been paid over to the appropriate third parties (e.g. Inland revenue, pension scheme or trade union) on time and in the correct amount. These include reasonableness checks and agreement with PAYE returns.
vi. Controls to ensure holiday pay is calculated correctly and paid in accordance with the terms and conditions of individual's employment contracts.
vii. There should be custody controls over unclaimed wages and their collection.

(b) The techniques I will use to check the existence of employees are as follows.

i. I will make a selection of employees from the payroll (because I am only interested as auditor in employees who are paid.)
ii. I will check these to the personnel records to ensure that their appointment had been authorized by the managing director and that they had joined but not left at the date selected.
iii. I will ensure that a valid clock card and production record was available for each employee relating to the payroll week from which selection was made.
iv. I will check the signature of each employee made against the collection of their wages for the particular week selected and ensure that this agreed to the signature held on the personnel records
v. Finally I will ensure that each employee had a valid National Insurance Number and PAYE code, and that they were recorded on the annual returns to the Inland Revenue.

(c) I will compile a list of starters and leavers between dates (perhaps six months apart) from personnel records of staff starting and leaving dates, checking that these records have been authorized by a responsible official.

The payroll at each of these two dates can then be examined and it will be possible to check that, for employees leaving between the two dates, there is no pay shown at the later date and that for employees joining there is no pay at the earlier date. (I will check, respectively, the two weeks after and before the event). If the examination of the payroll at the two dates revealed other apparent starters or leavers, these instances would be investigated.

The payroll should be scrutinized around the date of starting or leaving for a sample of starters and leavers in order to ensure that pay starts or ceases at the appropriate date. This test needs to take into account any special procedures, which apply. For example, leavers may be paid final holiday pay early, on the date they cease work but prior to their date of officially ceasing employment. Similarly, special arrangement might apply to the pay of employees joining.

(d) Analytical procedures that can be used in auditing the wages systems include the following.

i. Comparison of weekly payroll cost at the beginning and end of the period under review. Obtain explanation for differences.
ii. Calculate average wage per employee and consider for reasonableness (compared to the previous year). I will take account of pay rises according to union negotiations etc.
iii. Compare the proportion of payroll expense allocated to different departments, e.g. admin, distribution, to that of previous year. Investigate any significant differences.
iv. Check that pension contributions are at the expected level for gross pay, according to the company's scheme.
v. Calculate the ratio of wages to sales. Compare with prior years.
vi. Check the ratio of statutory deductions to gross wages. Consider reasonableness given fixed PAYE/NSSF rates and also compare with prior year

QUESTION THREE

a)

Factors to consider before accepting the assignment

When a professional accountant is approached by a prospective client to accept an assignment and another professional accountant is providing auditing services to that prospective client the factors to consider are: -

a. Whether there may be reasons, professional or otherwise why the assignment cannot be accepted.
b. Whether there are adequate resources in terms of manpower and skill to perform the assignment
c. Whether the timing and other requirements of the client are realistic

After considering the above factors the accountant then follows the following procedures before accepting the appointment.

1. Holds a meeting with the directors of the company to establish in detail the aims of the investigation, the scope of the investigation, the degree of detail required, the degree of secrecy required, the cost of assignment the timing requirements, including the period to be investigated and the employees to be investigated. These discussions are essential to form the basis of the engagement letter, which should be received before the work can begin.
   The accountant must obtain precise written instructions.

2. The accountant must observe professional etiquette or courtesies by informing the auditor, Mr. Solo, of the fact that he has been approached to accept an assignment to investigate fraud in his client. In addition to observing usual courtesies, this helps

to obtain the cooperation of the auditors, as it may be required at some point. The accountant ensures that he obtains the permission of the prospective client to communicate with the auditor.

a) Internal control weaknesses and accounting problems in small entities.

When a company is small the following characteristics are clearly apparent.

1. There is a concentration of ownership or operational control in one or a few individuals (owner-manager dominance).
2. There is a limited segregation of functions within the accounting system because of the small number of employees.
3. There is greater potential for management override of internal accounting controls.
4. Management personnel or employees have limited accounting knowledge.
5. There is an inactive or ineffective policy making body (e.g. Board of Directors).
6. Clerical personnel have easy access to assets.
7. Management does not hire or is unable to hire employees who have accounting experience or formal accounting training.
8. Record-keeping systems are often informal and documentation of transactions inadequate.

However because the transactions are few in number, the owner-manager is able to exercise direct supervision and authorize all transactions.

When a small company grows rapidly inevitably the systems of accounting and internal controls do not keep pace with this growth and broadly one ends up with a big business tied down to small company systems. The following internal control weakness and accounting problems can then normally be expected.

1. The owner manager is over stretched and cannot exercise adequate direct supervision, leading to increased errors and irregularities on the part of the staff.
2. Segregation of functions is not adequate and the increased volume of transactions will now contain more errors and give room to irregularities as the owner manager delegates some of his functions to overworked and not properly trained and competent staff.
3. Regular financial management reports essential for controlling the business are not readily available on a timely basis nor are they complete and accurate as the accounting records are inadequate to cope with the increased demands.
4. The assets of the company can easily be misappropriated as the primary records like registers may not be available and the staff that maintains the records have access to the assets they record, therefore opening opportunities for theft and concealment.
5. Accounting systems and related internal controls are not planned and get added on haphazardly to deal with any current crises. As such even the computerization action is not properly planned with the result that a few employees may be in a position to process and record complete transactions without any other authorization.
6. Whereas supervision checks on the excesses of junior staff there are usually no means of checking on the activities of the management.
7. Accounting records and documents are ill designed to facilitate complete and accurate documentation or recording of transactions.
8. Limited exposure of staff to accounting matters result in use of inappropriate accounting policies.

b) The controls that could have assisted in the prevention or timely detection of fraud.

1. Maintaining a list of approved subcontractors detailing

- The total contracted amount due to each sub contractor and
- Cumulative total payments to date

2. Pre numbering engineering certificates, insisting on their being issued in numerical sequence with the original copy faxed by the engineer being subsequently submitted to head office for comparison with the faxed one.
3. An independent person at head office should have been charged with the responsibility of checking the faxed certificates to confirm the signatures of the engineers, check for the reasonableness of the amounts certified, check for the numerical sequence of the certificates, then prepared the list of genuine claims for approval by the directors before the preparation of the magnetic tape containing the payments.

4. The bank should have been asked to provide a hard copy list of actual payments effected. These should have been compared to those approved to detect any other payments fraudently inserted.
5. Project cost analysis should have been prepared regularly with comparative contract amounts and submitted to the engineer in charge to examine and review and confirm that the costs were reasonable.

   The directors should also have reviewed these analyses and sought explanations for significant fluctuations of variances

6. The work of the computer operators should have been supervised and then checked for completeness and accuracy by a senior officer before the magnetic tape was release to the bank for paying.
7. An audit trail should have been maintained by ensuring that a printout is produced of all processing done by a computer. A director should then have checked them regularly to detect apparently fictitious entries.
8. Unused important stationery, such as the engineer's certificates should have been kept under lock and key and if pre numbered their use controlled by a register.
9. Use of the fax machine should have been controlled to ensure that only valid authorized documents are transmitted.

QUESTION FOUR

(a) **Letter of representation**

1) Purpose

During the course of the audit many representations are made by management to the auditors. Some of these are in response to direct enquiries by the auditors, others are implicit in the preparation of financial statements that are fairly presented. Most of these representations will be confirmed during the course of the audit by more reliable evidence such that reliance no longer need be placed on management representations. For other representation, however, there will be no independent corroboratory evidence available. The letter of representation, therefore, provides formal confirmation as to the representations made. In doing so, management may be encouraged to reflect more fully on the completeness of the representations made and provide further information that may earlier have been overlooked.

2) Reliability

Failure, by the auditors, to confirm such representations in writing would constitute negligence. However, it is important that auditors do not place reliance on representations where more reliable evidence would be expected. The absence of corroboratory evidence would, in itself, be suspicious and should lead to further audit enquiry. Moreover, written representations do not necessarily constitute sufficient evidence. The auditor must consider all available evidence and its reliability in forming an opinion. For example, in a small business where significant audit reliance must be placed on management representations, auditors may occasionally form the view that, even with written representation by management, there is insufficient evidence on which to form an opinion.

3) Matters included

Matters that may be included in the letter of representation include representations that:

- All books of account and supporting documentation, registers, minutes of members and directors meetings, have been made available;
- All related parties have been identified
- The entity is not in breach of any contractual or regulatory requirements that could have a material effect on the financial statements.
- The entity has title to all its assets and none are pledged or otherwise assigned other than disclosed in the financial statements.
- All liabilities and provisions have been reported or disclosed in the financial statements.
- All subsequent events have been properly reflected or disclosed in the financial statements.
- There are no plans that may significantly alter the carrying value of any of the entity's assets.

Note: Only three are required. Other matters may also be considered relevant.

4) Refusal

If management refuse to provide written representation as requested, the reasons would need to be enquired into the effect on the overall sufficiency of evidence considered. Generally, if a matter is sufficiently important as to warrant a request for its inclusion in the letter, a failure to obtain written representation would normally constitute a scope limitation resulting in the issue of a modified audit opinion which is either qualified or which a disclaimer of opinion is issued.

(b) **Management report.**
Procedures

Timeliness

Communication of control weaknesses is normally made shortly after completion of the audit. On larger engagements where controls risk was assessed during an interim visit, a letter should normally be sent after that visit as well as on completion of the audit.

Occasionally the matter may be sufficiently serious as to warrant more timely communication, such as where the exposure to risk is great or where there is reason to suspect that fraud or failure to comply with laws or regulations may already have occurred as a result of the weakness.

Method

As is implied in the title commonly given, the communication is normally made in the form of a letter. Often, however, a preliminary meeting is held with management directly responsible in order to confirm the understanding and to discuss the most appropriate form of changes to the system. The letter is, therefore, more likely to be accepted and its recommendations acted upon.

Oral communication may also be appropriate for weaknesses that are in urgent need of correction followed up by a written communication

Level of management
As mentioned above, it is common to discuss the detailed recommendations with line management before issuing the letter. The letter would normally be addressed to the chief financial officer. The letter may refer to minor matters in brief with more detailed recommendations being sent to financial officers of divisions or subsidiaries. More serious matters may be communicated directly to the board of directors or, if the entity has one, the audit committee. These would include such matters, as previous recommendations have not been implemented where the auditors believe the risks to the entity are material.

(i) Auditors responsibility

The auditors are not primarily responsible for evaluating the effectiveness of all internal controls and reporting all weaknesses. In the letter of weaknesses and in the engagement letter the auditor should make it clear that the assessment of control effectiveness is restricted to those controls on which reliance is intended to be placed for audit purpose. If auditors intend to place reliance for particular financial statement assertions wholly on substantive procedures, they have no responsibility for controls over those assertions.

Where the auditors do become aware of internal control weaknesses, however there is an expectation that they will warn management where the risk of loss or misstatement is considered material. Awareness of control weaknesses may come about from procedures other than those directed specifically at testing controls. For example, in obtaining an understanding of the system the auditor may become aware of major control weaknesses. Also, in performing substantive procedures, investigation of errors may alert the auditor to the presence of control weaknesses.

The auditor's duty to report on the effectiveness of internal controls, under auditing standards is confined to the management of the entity. They have no responsibility to report to other parties. The letter of weakness normally carries a disclaimer of responsibility to any other person to whom the letter might be shown.

Auditors may accept engagements to report on control weaknesses, either to managers, to regulators or to third parties. However, such engagements are not part of the audit of the financial statements.

QUESTION FIVE

a) The main objectives usually associated with audit committees include;

i. Increasing public confidence in the creditability and objectivity of published financial information including unaudited interim statements
ii. Assisting directors (particularly non executive directors) in meeting their responsibilities in respect of financial reporting
iii. Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

b. It is recommended that companies should have a committee of the board called the audit committee. This would consist of at least three non-executive directors with written terms of reference which Cleary deal with its authority and duties.

c. An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards
- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditors examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc
- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

(d) The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

(e) It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non-executive members of the audit committee can be suitably independent may be difficult to achieve.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

MOCK FOUR

QUESTION ONE

Tutorial note: *These model answers are considerably longer and more detailed than would be expected from any candidate in the examination. They should be used as a guide to the form, style and technical standard (but not length) of answer which candidates should aim to achieve. However, these answers may not include all valid points mentioned by a candidate – credit will be given to candidates mentioning such points.*

1 Amber Pan Europe

(a) Principal business risks

Tutorial note: *The requirement to 'identify and describe' suggests that although marks will be awarded for the mere identification of risks from the scenario (e.g. 'communications industry'), those risks must be described (as illustrated below).*

Communications industry

- Rapid and new technological developments in the industry, providing faster data transmission and increasingly interactive capabilities, will render certain existing products and services obsolete.
- Amber cannot predict how emerging and future technologies (e.g. cordless technologies such as 'Bluetooth') will affect demand for its services.

Competition

- Although Amber may have reduced competition in the short-term (by having acquired a competitor), the communications market is still expanding. Increasing competition from other existing and new competitors offering new technologies could:
  - affect Amber's ability to attract and retain customers
  - reduce Amber's share of new customers
  - force Amber to reduce prices.
- The cost (and revenue-generating capabilities) of new technologies tends to fall significantly and relatively quickly (e.g. mobile phone technology is now available in disposable form).

Integration

- Combining two groups which have previously operated independently (and competitively against each other) is likely to result in disruption.
- Potential difficulties may be encountered in seeking to retain customers and key personnel.
- The anticipated 'significant synergies' (in revenue, cost and capital expenditure) may have been optimistic. If they do not materialise to the extent predicted, Amber's operational activities, financial condition and future prospects are likely to be adversely affected.
- Amber may have difficulty in adapting its corporate image to the culture of the East African network.
- Operating losses
- Loss before taxation has doubled. If Talc was making significant losses before it was acquired by Amber those losses may have been expected to continue in the short-term. Although the group's operations are being combined and synergies are expected, clearly recurring losses will threaten the new group's operational existence as a going concern.

Falling ARPU

- ARPU, a key performance indicator, has fallen by 8·3% for contract customers and 14·8% for prepaid customers (% calculated on 2001 actual).

Sustaining growth

- Growth may not be sustainable as further expansion will incur significant costs and investment which must be financed.

- The significant costs expected to be incurred in upgrading networks may not be recouped if additional revenues are insufficient. Failure to maintain existing networks is likely to result in a loss of customers and market share.
- If Amber's financial resources are insufficient to meet the operating losses it may need to issue equity and/or increase its debt. Possible adverse consequences of increasing indebtedness include:
  - high debt-service costs
  - operating and financial restrictions being imposed by lenders
  - difficulty in obtaining further finance in the future
  - being unable to take advantage of business opportunities
  - reduction in credit ratings.

Tutorial note: *Although there are relatively explicit pointers to the above business risks in the scenario, marks will also be awarded for other risks which are perhaps more implicit (as illustrated below).*

Countries of operation

- Operations have been expanded from European countries to East Africa. Amber's inexperience of economic and legal developments in East Africa may impair the investment in Socolla.

Foreign exchange rates

- Amber transacts business in several countries and foreign exchange rate fluctuations could have a material adverse effect on operating results.

Highly regulated market

- Network operations could be adversely affected by changes in the laws, regulations or government policies which regulate the industry.
- Difficulties in obtaining approvals for the erection and operation of transmitters could have an adverse effect on the extent, quality and capacity of Amber's network coverage.
- Allegations of health risks (e.g. associated with radio waves from transmitter masts and mobile handsets) could reduce customer demand and increase exposure to potential litigation.

Tutorial note: *Candidates are not expected to have knowledge of industry-related complexities (e.g. of licensing, subsidies and network recharging) – however, appropriate marks would be awarded for comments on such business risks arising.*

(b) Impact of acquisition on planning

Group structure

- The new group structure must be ascertained to identify the entities which will be consolidated into the group financial statements of Amber for the year ending 30 June 2002.

Materiality assessment

- Preliminary materiality will be much higher, in monetary terms, than in the prior year. For example, if a % of turnover is a determinant of preliminary materiality, it will increase by 55% (based on estimate).

Tutorial note: *'Profit' is not a suitable criterion as group is loss-making.*

- The materiality of each subsidiary should be assessed, in terms of the enlarged group as at the planning stage. For example, any subsidiary contributing more than 10% of the group's assets and turnover (but not result!) is material and less than 5% (say) is not. This will identify, for example:

  - those entities which will require an audit visit; and
  - those for which analytical procedures may suffice.
- If Socolla is particularly material to the group, Riebeck may plan (provisionally) to visit Socolla's auditors to discuss any problems shown to arise in their audit work summary (see group instructions below).

Goodwill arising

- The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and the period over which it is to be amortised.
- The assets and liabilities of Talc and Socolla, at fair value to the group, will be combined on a line-by-line basis and any goodwill arising recognised.
- The calculation of the amount attributed to goodwill must be agreed to be the excess of the cost of the acquisition over the fair value of the identifiable assets and liabilities existing at the date of acquisition (Talc – August 2001, Socolla – May 2002).
- Significant non-current assets such as properties are likely to have been independently valued prior to the acquisition. It may be appropriate to plan to place reliance on the work of expert valuers.

Tutorial note: *As the Q refers to the audit of the 'consolidated financial statements' the audit of the investments in subsidiaries and the need for a provision against Talc, if it is a loss-making subsidiary, in the individual company accounts is of less relevance.*

Group (related party) transactions and balances

- A list of all the companies in the group (including any associates) should be included in group audit instructions to ensure that intra-group transactions and balances (and any unrealised profits and losses on transactions with associates) are identified for elimination on consolidation.
- It should be confirmed at the planning stage that inter-company transactions are identified as such in the accounting systems of all Amber companies and that inter-company balances are regularly reconciled. (Problems are likely to arise if new inter-company balances are not identified/reconciled. In particular, exchange differences are to be expected.)

On analytical procedures

- Having brought in the operations of a group of companies (Talc) with similar activities may extend the scope of analytical procedures available. This could have the effect of increasing audit efficiency.

Socolla on Income Statement

- The effective date of the acquisition of Socolla may be so late in the financial year (only 4–8 weeks, say, before the year end) that it is possible that its post-acquisition results are not material to the consolidated income statement.

Other auditors

- Other auditors will include:
  - any affiliates of Riebeck in any of the countries in which Amber (as combined with Talc) operates; and
  - the unrelated auditors (of Socolla).
- Riebeck will plan to use the work of Socolla's auditors who are Chartered Certified Accountants. Their competence and independence should be assessed (e.g. through information obtained from a questionnaire and evidence of their work).
- A letter of introduction should be sent to the unrelated auditors, with Amber's permission, as soon as possible (if not already done) requesting their co-operation in providing specified information within a given timescale.
- Group instructions will need to be sent to affiliated and unrelated auditors containing:
  - proforma statements

- a list of group and associated companies
- a statement of group accounting policies (see below)
- the timetable for the preparation of the group accounts (see below)
- a request for copies of management letters
- an audit work summary questionnaire or checklist
- contact details (of senior members of Riebeck's audit team).

Accounting policies (Talc & Socolla)

- Whilst it is likely that Talc has the same accounting policies as Amber (because, as a competitor, it operates in the same jurisdictions) Socolla may have material accounting policies which do not comply with the rest of the group. Riebeck may request that Socolla's auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

Timetable

- The timetable for the preparation of Amber's consolidated financial statements should be agreed with management as soon as possible. Key dates should be planned for:
  - agreement of inter-company balances and transactions
  - submission of proforma statements to Riebeck
  - completion of the consolidation package
  - tax review of group accounts
  - completion of audit fieldwork by other auditors
  - subsequent events review
  - final clearance on accounts of subsidiaries
  - Riebeck's final clearance of consolidated financial statements.

Tutorial note: *The order of dates is illustrative rather than prescriptive.*

(c) Use of analytical procedures

Tutorial note: *Candidates will be expected to know f that analytical procedures* ***must*** *be used at the planning and review stages and* ***may*** *be used as substantive procedures. For good marks candidates at this level will be expected to apply such knowledge using the financial and operating information given in the scenario.*

At the planning stage

- Analytical procedures must be used at this stage (sometimes called 'preliminary analytical review'). Riebeck's knowledge and understanding of Amber's business will be assisted by the accumulation of information. For example:
  - The 55% increase in turnover should be commensurate with the purchase of the Talc group.
  - There is a downward trend in the key performance indicator (ARPU has decreased by 8·2% for contract customers and 14·8% for prepaid customers).
  - The number of contract customers has increased by 49·8%, the number of prepaid customers by 260%. This should reflect the acquisition of Talc's customer base, market expansion and perhaps shift in customer preference from contract to prepay.
- Analytical procedures can also be used to identify areas of potential business and audit risk. For example:
  - Although the 56% increase in cost of sales is in line with turnover, distribution and administrative costs have increased by nearly 70% – if Amber is not realising the cost benefits it expected through synergy, this is a business risk (see (a)).
  - Expenditure on R&D looks very low (0·36% of 2002 turnover – 0·49% for prior year). This could indicate a business risk e.g. Amber is not making sufficient investment in R&D (necessary in this industry). It could also indicate an audit risk – that Amber is capitalising development costs which do not meet the recognition criteria for an intangible asset
    (IAS 38 'Intangible Assets').

- Riebeck can use analytical procedures to assist in determining the nature, timing and extent of other audit procedures (i.e. audit strategy). For example, Riebeck might expect a high degree of disaggregation in available information (e.g. between the Amber and Talc companies). A detailed review of gross profit margins by European country may highlight those which require detailed substantive procedures (tests of details).
- Financial data (estimated June 2002) is already available for use at the planning stage. Riebeck should have prior knowledge of the reliability of such data (by considering how 2001's Actual compared with 2001's Estimated).

As substantive procedures

- Analytical procedures at this stage are optional. (Substantive analytical procedures ('SAPs') are based on the expectation that relationships which are known to exist may be expected to continue in the absence of clear evidence to the contrary. For example, the relationship between gross profit and sales revenue may be expected to remain constant unless there are changes in sales prices, sales mix and/or cost structure.)
- However, although the GP margin is almost constant for 2002 and 2001 – it is unlikely that Riebeck would use this for substantive purposes given:
  - the diverse nature of operations in its industry;
  - the multiple locations over which it operates; and
  - the fact that it is known that unit revenues are falling (due to market competition).
- Analytical procedures can themselves provide sufficient audit evidence where an item can be verified directly by reference to another (valid) item. For example, Riebeck may be able to substantiate the finance cost, depreciation and amortisation using a 'proof in total' or 'reasonable test'. The mechanics of this are that the expected value of the population (e.g. finance cost or depreciation) is:
  - calculated using base data (e.g. outstanding debt and % costs of debt or cost of assets and depreciation rates) which has been confirmed to be materially correct; and
  - compared with recorded value. Any difference is not expected to be material. Riebeck may find even such simple models to be very effective.
- Trend analysis (i.e. the comparison of current data with prior periods) may be particularly useful for analysing income (e.g. monthly revenue by customer type and market). Riebeck might expect that trends in the combined Amber and Talc are very similar whilst those in Socolla might be very different (e.g. because market penetration and growth may be less rapid). As ARPU is a key performance indicator, Riebeck might expect to find (or determine) comparable amounts in the financial statements of Amber's competitors. This could then be used to provide evidence concerning the completeness of recorded income. For example, (8,861 x 655) + (6,084 x 241) _ Kshs.7,270m (2001 – Kshs.4,700m). Recorded revenue is 4·3% (2001– 4·1%) more. This must be investigated (e.g. there may be sundry sources of revenue).

At the review stage

- Analytical review at this stage is required in forming an overall conclusion as to whether the financial statements as a whole are consistent with Riebeck's knowledge of the business. The review may also identify the need for further substantive procedures.
- Ratio analysis is particularly useful in testing the consistency of the inter-relationships of amounts disclosed in the financial statements. It is usual to compare ratios calculated at this stage with those of the preliminary analytical review.

QUESTION TWO

Aspersion

Tutorial notes

(1) the omission of recognition and/or disclosure as well as benchmark and alternative treatments).

(2) Many points can only be made as (and there is no relationship between the two that would warrant a columnar approach). However, some points could be made as either (or both) although the emphasis would need to be different. For example, a matter to consider is the audit program for the identification of related parties and RPTs, whilst the evidence will include copies of extracts from minutes and company registers and written management representation.

(1) Related party transaction ñ sale of cargo carrier

(i) Matters

- The cargo carrier was in use for 8/9 years and would have had a carrying value of Kshs.720,000 at 30 September 2000 (assuming nil residual value and a full yearís depreciation charge in the year of acquisition and none in the year of disposal). Disposal proceeds were only therefore Kshs.300,000 (say).
- The Kshs.400,000 loss represents 15% of profit before tax and is therefore material. Disclosure as a separate line item may therefore be appropriate (IAS 8).

Abra appears to have a related party relationship with Aspersion as Iain:

- is one of the key management personnel of Aspersion (being the finance director); and
- has an equity interest in Abra which is presumed to constitute significant influence (being greater than 20%).

This relationship will be further strengthened/closer/more apparent if:

- Iain is also a shareholder of Aspersion and/or a director of Abra;
- any close members of Iainís family are also shareholders of Abra (being a private company).

The reason for the sale e.g. whether this aircraft was:

- surplus to operating requirements (i.e. not being replaced); or
- being replaced with a newer model (perhaps more likely as total assets have increased by $600,000 during the year).

The reason for the loss on sale e.g. whether the:

- sale was at an under-value (if the sale to the related party was not at armís length);
- aircraft had a bad maintenance history (or was otherwise impaired);
- useful life of a cargo carrier is less than 20 years.
- If the latter, it is likely that tangible non-current assets are materially overstated in respect of cargo carriers still in use.
- How selling price was determined. For example, whether the asset was independently valued or whether this was Abraís best offer. Also whether there were any other unrelated potential purchasers or offers made.
- The principal terms of the sale e.g. for settlement of the purchase price.
- The board was aware of the related party relationship (as it was minuted) when the sale was approved.
- Whether RPTs have been identified and disclosed in prior period financial statements.
- The related party relationship and the sale of the cargo carrier to Abra should be disclosed in a note to the financial statements for the year to 30 September 2001. The elements of such a material transaction which are likely to be necessary (for an understanding of the financial statements) are:
  - the amount(s) involved (i.e. sale proceeds and loss);
  - any outstanding balance of amounts due from Abra;
  - how price was determined (e.g. by an independent valuation).

If suitable disclosure is not made, the audit opinion would be qualified except for disagreement (non-compliance with IAS 24 Related Party Disclosures).

(ii) Audit evidence

- Notes on the clients' procedures for the identification of RPs and RPTs.
- Any list of known RPs on the permanent audit file should be evidenced as having been updated.
- Extracts from statutory records e.g. principal shareholders (from the share register) and directors' interests (from the register of directors' interests).
- A copy (or extracts) of any valuation report on the carrier.
- A copy of any advertisement placed for the sale of the carrier.
- Extracts from correspondence with Abra (and any other potential purchaser).
- A copy of the sales invoice (or other document transferring title to Abra).
- Evidence of receipt of proceeds (e.g. vouched to cash at bank) and direct confirmation from Abra of any amount outstanding at 30 September 2001.
- Carrying amount (cost less accumulated depreciation) agreed to the fixed asset register and recalculation of the loss on disposal. (Also, purchase price agreed to prior year working papers, fixed asset register, etc.)
- A review of maintenance expenses and records (e.g. to confirm reason for loss on sale).
- Proposed wording for the note disclosure in the financial statements.
- Written management representation that there were no RPs or RPTs required to be disclosed in the financial statements other than those which have been disclosed (completeness assertion).
- Audited accounts of Abra (where available) showing tangible asset additions of at least £1·2m.

(2) Impairment in light aircraft

(i) Matters

- The annual depreciation charge for each of these two aircraft is Kshs.30,000 (1/15 × 450,000). The aircraft have been depreciated for only 2½ years to 30 September 2001 (assuming time apportionment in 1999 when the aircraft were brought into use) and have a total carrying amount of $750,000 (2 × [450,000 ñ (2½ × 30,000)]). This represents 7·2% of total assets (and some greater % of tangible non-current assets) and is therefore material.
  Tutorial note: *Alternatively it could be assumed (though less appropriate) that a full years depreciation was charged in the year to 30.9.99 (i.e. three years accumulated depreciation to 30.9.01).*
- The aircraft were purchased for a specific use which will cease six months after the balance sheet date. The value of the aircraft may be impaired and Aspersion should have made a formal estimate of their recoverable amount (IAS 36).
- Whether management has estimated net selling price and/or value in use.
- Whether Aspersion prepares management accounts and budgets and has experience in projecting cash flows (for determining value in use). Managements intentions, for example:
  - to sell the aircraft;
  - to find an alternative use (e.g. providing other business or pleasure flights).

The amount of any impairment loss identified and whether or not it is:

- material (say Kshs.100,000);
- to be recognised in the financial statements.

Additional point

If the passenger business constitutes a business segment (IAS 14), cessation of the contract may result in a discontinued operation (IAS 35).

(ii) Audit evidence

- A copy of the service contract confirming expiry in March 2002.
- Physical inspection of aircraft (evidence of existence and condition at 30 September 2001).

- Notes of discussions with Aspersionís management concerning negotiations for:
- the sale of the aircraft; or
- obtaining new service contracts.
- Extracts from any correspondence.
- A copy of any (draft) agreement for:
- the sale of the aircraft after the contract expires;
- new business or pleasure contracts.
- Discounted cash flow projections for any proposed new venture/contracts (i.e. value in use).
- Comparison of projected cash flows with budgets and assumptions (e.g. aircraft days available and average daily utilisation per aircraft).

(3) Deferred tax ñ change in tax rate

(i) Matters

- The total provision amounts to 21% of PBT and is therefore material. (However the deferred tax expense/income for the year may not have been material.)
- Under IAS 12 deferred tax is calculated on the temporary differences between the tax base and carrying amount of assets.
- The increase in liability if calculated at 34% ($570,000 × (34/30 ñ 1) = $76,000) represents 2·8% of PBT. Considered in isolation, this amount is not material.
- The tax rate that should be used is the rate that is expected to apply to the period when the liability is settled, based on tax rates that have been (substantively) enacted by the balance sheet date (IAS 12). The increase in tax rate announced on 1 December is a non-adjusting post balance sheet event (IAS 10).
- Also, the extra 4% does not meet the definition of a liability (ëa present obligation arising from past events) and no provision should be recognised (IAS 37).
- If the directors adjust the draft accounts there will be non-compliance with IASs 10, 12 and 37 which may be regarded as material by nature.

(ii) Audit evidence

- A copy of the computations of:
- deferred tax liability (balance sheet);
- current tax expense (income statement);
- deferred tax expense/income.
- Agreement of tax rate(s) to tax legislation.
- A numerical reconciliation between tax expense and accounting profit multiplied by the applicable tax rate.
- Schedules of carrying amount (i.e. cost or revalued amounts net of accumulated depreciation) of non-current assets agreed to:
  - the asset register (individual assets and in total);
  - general ledger account balances (totals).
- Completed audit program for tangible non-current assets (e.g. inspecting invoices for additions, agreeing depreciation rates to prior year accounting policies, etc).
- Clients schedules of tax base agreed, on a test basis, to:
  - the asset register (for completeness);
  - prior year working papers (completeness and accuracy of brought forward balances).

QUESTION THREE

a) The programmed access controls that I would accept to have been incorporated into the electronic funds transfer system used by Beeys Ltd. would include:
   1. That the microcomputer at the head office of Beeys Ltd. linked to the mainframe computer of the bank through a dial up link means that the 2 machines communicate

through a telephone line. This means that there is a danger that communication between the 2 computers could be interpreted and transmission expected without proper authority. Therefore I would expect that built into the system would be the provision of a dedicated line at Beeys Ltd. such that when the mainframe computer receives a signal from Beeeys Ltd it will not accept instructions directly rather it would call back at the dedicated number at Beeys Ltd. to facilitate the dial up link.

2. All authorized users should have been issued with passwords or some other form as identification such that once the dial up link has been facilitated the system should demand for a password which must be keyed in. In this way different levels of access can be given to the staff e.g. the purchases ledger clerk can access the system for reading purposes only without the authority to effect any transfers.
3. The password has to be keyed in for the computer to determine the degree of access the password holder is permitted.
4. The system should have been programmed that transfers can only be effected at certain times like between 11 a.m. and 3 p.m. on a working day. When any attempt iis made to effect transfer the system checks against its in built clock and confirm that time access is being attempted is reasonable.
5. A comprehensive creditors master file should have been built up with all details of the creditors bank and the account number at that bank. These details would have to be keyed in when a transfer is to be made. The creditors master file must be on line when transfers are being effected so that the system automatically performs a master file check to ensure that the company does have such a supplier. At the same time the programme would also perform a reasonableness check that the proposed amounts to be transferred do not exceed the amount due to that supplier.
6. A delay mechanism should have been built into the system such that when the instructions to transfer are given mainframe does not effect the transfers until say after 24 hours.
7. Both ends of the system should have been programmed to automatically prepare a record of the transfers that have been effect so that when the bank statement ius received from the bank it can be marched against the list of authorized transfers by Beeys ltd.
8. A limit should have been built into the system such that only transfers below this amount should be effected by line system, any amounts in excess should be rejected requiring a cheque signed by the authorized signatories.
9. A requirement should have been in place that passwords should be changed regularly. There should have been built into the system to deny access or refuse to act on the instructions of a password users who has not changed their password within the stipulated time.
10. Should have built into the system a, mechanism for the system to close down automatically if a wrong password is entered more than 3 times.
11. Similarly it should close down it require the password to be keyed in again if no activity takes place when the 2 machines are linked for a period of time, say 5 minutes.
12. Should have built into the system a mechanism that informs the mainframe computer the number of transfers to be effected so that once many transfers have been effected the dial up link is immediately disconnected.

b) The additional measures that Beeys Ltd. should take in order to prevent unauthorized transfers:

i. Ideally the micro computer used at Beeys Ltd. to transfer funds should be located in a secure office to which access is restricted to only authorized personnel at approved times. This is the normal lock and key. Ideally the computer should not be used for another purpose.

ii. The microcomputer that facilitates the dial up link could be required for other work therefore it may both be practicable to only use it to effect transfers. Therefore the software that facilitates transferring of funds through a dial up link should not be

resident on the micro computer hard disk, a compact disk with the software should always be under the custody of a librarian or some other senior officer who will always record when the software was taken to be used, who took it and when it was returned. As such, it should only be loaded when the transfers are to be effected.

iii. There should be restrictions on opening new accounts for suppliers or removing names of suppliers from the creditors master files or even changing the supplier details. There should be pre printed, prenumbered change forms when a new suppliers has been approved by the purchasing committee and their details entered in these forms would be approved by both the chief accountant and purchase committee.

iv. There should be arrangements for the creditors master file to be regularly dumbed and normally checked.

v. Before any transfers are effected the invoices to be paid should be subjected to a payment selection criteria. They should have been supporting documents attached to them. A list should be prepared and it should have the written authority for the transfers to be effected in the form of a signature by the cheque signatories and this list should be retained.

vi. Once the transfers have been effected the supporting documents should be stamped and cross referenced to the transfer number.

vii. At almost all the times of the month only the minimum balance should be retained on this bank account. When the list if transfers to be effected has been approved the money can then be transferred from the main account to this account for the transfers to be made.

viii. Regular bank reconciliations should be prepared, reviewed by responsible officials and approved. Any long outstanding items should be investigated.

ix. Reconciliations of creditors statements should be regularly prepared, the long outstanding reconciling items being investigated.

c) The greatest risk company is exposed to by joining the EDI network would be that of a computer virus infection. A computer virus has been described as a computer program that can affect other programmes by modifying them in such a way as to include a possibly evolved of itself. Generally speaking however any deliberately caused computer problem is capable of spreading itself can be regarded as a virus.
Just like a biological virus invades the human body and multiplies to a level sufficient to interfere with the workings of body organisms a computer virus is a set of alien instructions inserted into a program that takes control of the computer operating system and in its own time orders the machine to do its bidding. Most biological viruses are transmitted through a physical contact similarly, a computer virus can be passes on from one program to another through inserting a clen disk into a machine that has already been in contact with an infected program., Viruses can also be spread to a computer in a situation where the machines are linked through telephone lines. It is not unusual therefore for just one contaminated machine to send out a wave of infection spreading to thousands of other computers in a matter of seconds. Therefore if the computer becomes linked to a network it stands the risk of having its information corrupted should any of the machines in the EDI network become infected. Any other microcomputers within Beeys Ltd. can also be infected by the interchange of diskettes between the microcomputers.

QUESTION FOUR

CLIENT: MACHO LTD YEAR ENDED 30th NOVEMBER 1993

MATTERS FOR THE PARTNERS ATTENTION

1. CHEQUES MAILED AFTER THE YEAR END

Cheques amounting to Kshs.661,180 were drawn on the last day of the year and processed through the cashbook, creditors ledger and the general ledger. The draft accounts have been prepared on the basis of that general ledger. However these cheques were not mailed to the payee until several days after the year-end. The draft accounts are therefore reflecting that a payment had been made by the year-end when the reality is that no payment had been made by then. Consequently both creditors and cash at bank have been understated by this amount i.e. Kshs.661,800.

2. USE OF THE WRONG PRICE LIST

A new price list which was to be effective on 1st December was used in November resulting in some customers being overcharged a total of Kshs.1,140,230 A revealed by our credit tests. when management became aware some time in December, an estimate in the amount of kshs.650,000 was arrived at to account for the credit notes that would subsequently have to be issued to the customers to correct the overcharge. A provision against debtors was made in these amounts. The account treatment of the poor bad debts was incorrect. Sales should have been debited to reverse the overcharge. Turnover is overstated by the whole amount of Shs.1,140,230 but debtors and profit before tax are understated by the different of Kshs.490,230.

3. CAPITALISATION OF REPIAR ITEMS

Additions to plant and machinery during the year totaled Kshs.3,380,000. To verify the validity of these additions a representative sampling test was conducted selection being on a random basis. Sample selected at Kshs.845,000 in value was 25% of the entire population. In the sample we detected repair items amounting to Kshs.162,500. When we informed the client these errors were corrected in the draft accounts. We have requested the client to locate the supporting vouchers or documents for the remainder of the population that was not tested so that we shall peruse them together with a view of determining the actual repair items still included in additions to plant and machinery. If we project the error rate to the whole population then these repair items still capitalized approximate to Kshs.487,500.

4. LIRA PURCHASES

During the year the company began to import components from Italy. The related supplier invoices were in Italian were in LIRA. Some of these items were in stock at the balance sheet date. They were valued for financial status purposes using the year end exchange rate for LIRA . This accounting treatment is in contravention of the provisions of IAS 21. The effect of changes in foreign exchange rates which recognizes stocks, fixed assets and share capitals as non monetary items that should be carried in the financial status using the exchange rage ruling when the transactions that brought them into being took place. Our credit tests have revealed that there was negligible movement in the exchange rate per LIRA between the transaction date and the balance sheet date, therefore the financial effect on the draft of accounting policies (which are part of the notes to the accounts therefore part if the financial status regarding transaction of denominate in foreign currency) is written as per this wrong policy they have adopted. We have requested the client to amend the accounting policy note to be in line with the requirements of the IAS 21 and also mentioned the matter in the management letter for the client to adopt the correct procedure in future.

5. WARRANTY PROVISION

We have checked the clients warranty provisions for repair works to be conducted and warranties issued and not claimed against. It currently stands at Kshs.1,625,000 our credit checks have indicated that it should be at least that amount but could be understated by as much as Kshs.325,000. The client is of the opinion that our view is too pessimistic. Please

review our workings in this area and use your experience to resolve this area with the client by establishing the additional provision that we could accept has not been unreasonable.

6. UNINSURED RISK PROVISION
Several years ago an uninsured risk provision in the amount Kshs.1,300,000 was set up to provide against unforeseen events yet no amounts have been charged against it. This provision does not pass the test of a liability. The provision is no longer required its inclusion in credit is unwarranted and should be reversed to reserves.

QUESTION FIVE

DEXY

(a) Non-cancellable lease

(i) Matters

- The principal issue is whether the lease payments should be:
  - capitalised (as an asset) and amortised; or
  - expensed as incurred.
- IAS 17 'Leases' requires that a finance lease should be recognised as an asset and a liability. Operating lease payments should be expensed in the income statement on a straight line basis over the lease term (or other systematic basis representative of the pattern of benefits consumed).
- Whether the non-cancellable lease is a finance or an operating lease depends on its economic substance rather than its legal form. Indicators of a finance lease are less likely to apply to this lease than an item of equipment (say). For example, seven years of use of a floor of a new office block development will certainly not be for the major part of such an asset's inherently long life.
- Kshs.770,000 represents 2·1% of total assets. This is likely to be considered material as the issue is whether this asset should be recognised in its entirety, or not at all.
- Whether Kshs.770,000 is the present value at inception of the lease (as required by IAS 17 in determining the amount recorded as an asset) or as calculated as at the balance sheet date (say).
- The basis of setting the discount rate used to calculate the present value if there is no rate implicit in the lease.
- Kshs.130,000 represents 4% of profit before tax. Not expensing the annual lease payment may, in isolation, be considered not material. Also, as the impact on the income statement is off-set by Kshs.110,000 amortisation plus finance charge, the net effect on profit before tax is insignificant. (There is no difference over the life of the asset.)
- The terms of the lease. For example:
  - whether or not there is any option to renew the lease at any time which suggests that Dexy would occupy the
  - premises for the duration of the suite's economic life;
  - whether title to the premises could under any circumstances be eventually transferred to Dexy.
- The extent to which Dexy bears the risks and rewards of ownership. For example, whether Dexy is responsible for payments of business rates, office maintenance, repairs, insurance, etc. Also whether Dexy has the right to sub-let office space to an independent party or whether Dexy can, for example, partition the office space without the lessor's consent.
- A finance lease gives rise to a depreciation expense. Dexy's depreciation policy (i.e. straight line) should be consistent with equivalent owned assets. Unless there is reasonable certainty that Dexy will obtain ownership by the end of the lease term, seven years will be appropriate (being the shorter of the lease term and the asset's useful life).

- The reason why Dexy's management should wish to capitalise the lease if it is an operating lease.

  Tutorial note: *The issue is usually the 'other way around' i.e. that management want to keep lease liabilities off the balance sheet by treating finance leases as though they are operating leases.*

- If, after examining the evidence, it appears that the lease should have been treated as an operating lease the auditor's opinion should be qualified 'except for' for non-compliance with IAS 17.

(ii) Audit evidence

- The suite of offices on the 13th floor – that they exist and are used by Dexy.
- The contract setting out the lease terms – to establish its legal form (more likely to be an operating lease than a finance lease) and interpret its economic substance.
- The nature and amount of office expenditure incurred by Dexy in respect of these premises, agreed to invoices, management charges, etc (to gauge to what extent the risks and rewards of ownership are borne by Dexy rather than the lessor).
- Recalculation of the present value of the minimum lease payments (should be as at inception of the lease).
- Recalculation of the pre-tax cost of capital of the discount rate used (if there is no rate implicit in the lease).
- Agree a Kshs.110,000 amortisation charge for the year to the income statement.
- Agree the completeness of disclosure of the minimum lease payments. For example:
  - Kshs.130,000 not later than one year;
  - Kshs.520,000 later than one year and not later than five years; and
  - Kshs.130,000 later than five years.

(b) Advertising costs

(i) Matters

- Kshs.350,000 budgeted expenditure represents 10·9% profit before tax and is therefore material.
- However, the amount which is being deferred (Kshs.125,000) is only 3·9% of profit before tax and 0·3% of total assets and therefore immaterial, when considered in isolation.
- Whether deferral of expenditures (as compared with immediate write off) constitutes a change in accounting policy. If so, whether it has been treated as such in accordance with IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies' (i.e. an estimate of the prior period prepayment adjusted against retained profit). If so, the impact on the current year income statement will be negligible.
- If Kshs.125,000 is time-apportioned from six month's expenditure, the actual annual cost could amount to an (4,125*k*) – 350*k* overspend of 40% (= 42·9%) 350*k*
- Advertising is an expense incurred to provide future economic benefits, but no intangible asset is acquired or created that can be recognised (because it is indistinguishable from internally-generated goodwill). It is therefore expensed when it is incurred (IAS 38 'Intangible Assets').
- IAS 38 does not prohibit the recognition of prepaid advertising expenditure. For example, costs incurred in December for advertisements which will go out after 31 March 2003, are prepaid.
- To the extent that costs incurred represent product catalogues which have not been distributed at 31 March they should be included in inventory rather than prepaid expenses (although the amounts involved are immaterial).

- The extent to which any relationship can be established between advertising expense incurred and revenue arising. For example, if revenue in April – June clearly corresponds to the New Year catalogues issued before 31 March 2003, this would support deferring the costs of those catalogues at the balance sheet date. (Similarly advertising costs.)
- If the prior period is not restated, the main impact of the change in policy will be a 'one-off' reduction in the expense charged to the income statement, in the year in which the change takes place. Thereafter, assuming advertising costs do not fluctuate significantly from one year to the next, the annual expense will be comparable year on year. (There will be a rising trend if annual expenditure increases year on year.)
- The reason why Dexy's management should want to make the change. For example, if there has been significant overspend on the advertising budget (see earlier calculation), carrying forward some of that cost will lessen the impact on the income statement.

(ii) Audit evidence

- Current year annual budget, by month, compared with prior year(s) and actual monthly costs incurred during the year to 31 March 2003 compared with budget and prior year. To see if there is evidence of under-budgeting/overspending that might have prompted the change in accounting policy.
- Supporting invoices for major items of expense incurred in June and December (e.g. for the design of the advertisements and the printing of the product catalogue, etc)
- The make-up of $125,000 prepayment. If actual costs approximate to budget and similar amounts are spent in December as in June, the prepayment at 31 March 2003 for the three months to 30 June would be expected to be only *c.* Kshs.90,000 (i.e. 350,000 ÷ 4).
- The number of product catalogues held and included in the inventory valuation at the balance sheet date. (The Kshs.125,000 includes the cost of catalogues in inventory so it would be 'double-counted'.)
- Artwork for the advertisements designed before the year end but not placed until after the year end – to confirm that the expense incurred should be deferred to the next accounting period.

(c) Painting

(i) Matters

- $1·35 million represents 3·7% of total assets per draft financial statements (i.e. including revalued amount) and is therefore material to the balance sheet.

  Tutorial note: *The impact on PBT is not assessed because it has no impact on the income statement.*

- The painting is an asset – i.e. a resource held by Dexy arising from past events (a purchase) and from which future economic benefits are expected to flow (e.g. when the investment is realised through an eventual sale).
- The asset has been held for 50 years and unless it is now held with a view to sale should be classified as
- non-current (IAS 1 'Presentation of Financial Statements').
- Management's future intention – to hold or sell this asset, to determine its classification as current or non-current.
- Dexy's going concern status and financial position. (Management's intention could be to hold the asset but as it is not used in day-to-day operations it would be the ideal asset to dispose of to raise finance.)
- The painting is clearly not held for use in the production or supply of goods or services. So unless it is held for rental to others or for administrative purposes, it is not an item of

property, plant and equipment (as defined by IAS 16). It is therefore not subject to an annual depreciation charge.

- Whilst it was displayed in the reception office it may (arguably) have been a furnishing for administrative purposes. However, as it has now been removed outside of the business premises its accounting treatment appears not to be covered by IAS 16.
- There is no IAS dealing specifically with such assets held for their investment potential.
- IAS 40 'Investment Property' though not applicable (as the investment is clearly not in property) may provide a suitable benchmark for Dexy's accounting treatment.
- Whether management intends to adopt a fair value model (i.e. to maintain it at fair value in the financial statements and include gains or losses arising on change in fair value to net profit or loss for the period) or regards this as a 'one-off' revaluation.
- To where in equity has the surplus been credited (e.g. a revaluation or other non-distributable reserve)?
- How the change in measurement policy could otherwise be treated (if not as a current year revaluation surplus). For example, applying IAS 40 transitional provisions, the credit should be to the opening balance of retained earnings. Comparative information should not (cannot!) be restated because fair value was not previously disclosed publicly (because it was not known).

  Tutorial note: *Neither the benchmark or allowed alternative treatments for changes in accounting policies under IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies' apply.*

- IASs (e.g. 16 and 40) do not permit selective revaluation of assets. Therefore, if Dexy holds any other paintings they too must be revalued.
- Whether the taxation authority might seek to tax the CEO now holding the asset.

(ii) Audit evidence

- Historic cost agreed to prior year working papers and financial statements.
- The revaluation report of the independent appraisal company, in particular, the assumptions made. For example, if the fair value is one which could realistically be achieved only through auction rather than a private sale.
- Insurance documents, stating the amount insured and any related conditions (e.g. security arrangements) and confirming that it is covered in its current location.
- Correspondence with the insurers – including the evidence the insurers required to confirm to their satisfaction the value of the painting. For example, whether the insurer relied on the revaluation report prepared for Dexy, or whether the insurer commissioned a further independent valuation.
- Physical inspection of the painting at the chief executive's residence and review of the security measures in place (as compared with those operating over the office environment).
- Confirm the adequacy of the disclosure made in the financial statements, in particular, the measurement basis described in the accounting policy note.
- Written representation from the CEO that the painting is in his safekeeping.
- Written representation from the management board confirming their intention to hold or sell the painting. If holding, then their intention to have the painting valued annually (or otherwise).

Tutorial note: *Marks will be awarded for suitable points about placing reliance on an independent expert valuer (e.g. to confirm the painting as an original). However, candidates should be mindful of the cost of such evidence and the availability of alternative evidence, as suggested above.*

MOCK FIVE

QUESTION ONE

A1.

The Director
Computer Maintenance
Services Limited
P. O. Box ABC
Nairobi

Tick and Cast
Certified Public Accountants
P.O. Box XYZ
Nairobi

Dear Sir,

We have commenced planning the audit of the financial statements for the year ending 30 September, 1990. As already mentioned in our letter of engagement dated 1 April 1990, our audit is designed to give us in the main reasonable assurance that the financial statements give a true and fair view as at the balance sheet date.

It therefore involves consideration of significant accounting policies adopted by the company as to their suitability.

It is generally held that for an accounting policy to be suitable it must be:-

i. Acceptable, i.e. in accordance with generally accepted accounting principles;
ii. Commonly adopted within that particular industry;
iii. Consistently applied over the years;
iv. Consistently applied throughout the enterprise;
v. Appropriate and applicable to the particular circumstances;
vi. In compliance with any relevant space IFRS/IAS
vii. Adequately disclosed in accordance with IAS 1, presentation of financial statements.

Our initial review of the significant accounting policies has revealed that the accounting policy adopted with regard to service contract income might not be suitable for the following reasons:-

i. One of the fundamental accounting assumptions is that of matching revenues with the costs of generating that revenue. These service contracts are for a three year period and the company therefore has to commit itself to costs over the period of the service contract.

   Accounting for income at the date of the contract but charging costs as they are incurred would imply that the company is not matching revenue with related costs. Contract revenue is so significant to the operations of the company that this policy would seem to be imprudent as profits are likely to be over stated.

ii. This policy is not commonly adopted within the industry in which you operate.

   We recommend that the contract revenue is credited to the profit and loss account over a three year period, based on the proportion of the actual cost incurred during each year.

For the financial statements to give a true and fair view we further recommend that amount of contract revenue taken credit for any one year be separately disclosed as a note for the financial statements, so that the reader of the accounts can determine the uncredited reserve at the beginning of the year, amount credited during the year, amount of new contracts entered into the year, the balance at the end of the year disclosed as unearned income.

Also the accounting policy note to the financial statements should disclose this accounting policy.

In our opinion adoption of this policy will ensure that the accounts present fairly the results from operations and the profits will not be overstated.

Please do not hesitate to contact us for any clarification you may consider necessary.

Yours faithfully

TICK & CROSS CAST
CERTIFIED PUBLIC ACCOUNTANT

QUESTION TWO

Azure

(a) Audit planning issues

Tutorial note: *'Planning an answer' means, as a minimum, deciding how marks are likely to be allocated and structuring the answer accordingly. In general, the more a question is broken down into parts, the less time needs to be spent on 'formal' writing out of an answer plan1. In this Q there are clearly three specific matters to be addressed. However, there are further explicit planning issues ('audit risks' and 'audit strategy' referred to in the second paragraph) as well as those implicit to planning (e.g. materiality and logistics).*

Risks

- Inherent risk is increased at the entity level as the company operates in geographically diverse locations. Also, the 'holiday' industry is very competitive and the collapse of major tour operators is not uncommon.
- Inherent risk is increased at the account balance and class of transactions level because, for example:
  - there are indicators of off-balance sheet financing (i.e. operating lease commitments on aircraft);
  - certain accounting policies may be imprudent (e.g. the point of revenue recognition is holiday departure).
- Revenue and profit may be overstated for holidays which commence before the year end, but the costs of providing those holidays are incurred after the year end. For example, an increasing number of early retirees take long vacations commencing December (say) over the winter months (January, February).
- That cash and cash equivalents exceed non-current assets reflects Azure's exposure to liquidity risk. The company needs to maintain a high level of liquid funds to meet its current liabilities (and operating lease commitments).
- Azure's implementation of policies and procedures (e.g. in its internal financial control system) suggest a risk-conscious management. The control environment is likely to be assessed as strong which is crucial if reliance is sought to be placed on internal controls.
  - The main financial risks likely to be faced by Azure are those associated with foreign exchange and fuel costs (also possibly interest rates).

Audit strategy

Tutorial note: *Although presented here as a 'general' point, this could be regarded as a conclusion and so appear at the*
end of a planned answer.

- A risk-based approach (either audit risk or business risk model) should be adopted given:

- the emphasis on risk required for the submission (and the existence of apparent risks);
- the likely need to rely on internal financial controls including the internal audit function (e.g. for multiple locations);
- that it would be inappropriate to adopt certain 'standard' tests of detail (e.g. to confirm trade receivables by direct confirmation);
- the scope for analytical procedures in providing substantive evidence.

- Analytical procedures on quarterly/monthly ('regular' per Q) actual, budgeted and prior year results may be used to effectively audit Azure's financial statements. For example, to review the reasonableness of actual seasonality in turnover by a comparison of budgeted and prior year amounts by location. Also, by 'proofs in total', to confirm the reasonableness of:
  - travel agency commissions
  - depreciation (not aircraft, as leased)
  - interest receivable on cash deposits.

Tutorial note: *See also (3) below.*
Materiality
Based on the 2000 accounts, preliminary materiality can be assessed to be approximately:

- Kshs.5m which lies in the ranges 1/2% – 1% turnover and 1% – 2% total assets.
- alternatively $2·7m which lies in the ranges 1% – 2% total assets and 5% – 10% PBT.

WORKINGS
1/2% – 1% turnover ≈ 4·7m – 9·4m
1% – 2% total assets (at least 109·1 + 29·7 + 138·6 = 277·4) ≈ 2·8m – 5·5m
5% – 10% PBT ≈ 1·4m – 2·7m

Tutorial note: *The assessment of materiality at the planning stage is its quantification. A statement that 'preliminary*
materiality is $x' is worth a mark (just) providing it is in a suitable range (say Kshs.2·5m – Kshs.5·5m). However, with an explanation of how it has been derived, it is worth 2 or 3 marks. Also, a materiality threshold outside of the suggested suitable range would also be awarded marks if justified.
Logistics

- The audit of Azure will require visits to a number of locations at the same time (e.g. the year end). For example, to verify the existence and condition of certain assets (e.g. aircraft).
- To visit all 13 holiday locations (and 29 outlets) would not only be costly, but unnecessary. A combination of:
  - visits to the offices of the most significant holiday locations (on a rotational basis); and
  - the review of 'branch returns' (from offices not visited), should provide sufficient audit evidence regarding the offices' transactions and balances.

(1) Sales & distribution

- Call centres are being increasingly used in the travel sector as a means of gaining competitive advantage through:
  - reduced costs (as compared with high street retail agents);
  - increased quality of customer service and satisfaction; and
  - convenience and speed.
- Most of the problems experienced in call centres relate to poor staff retention, high absenteeism and poor employee relations, which increase costs. Audit procedures on the payroll should include, *inter alia*, the analysis of labour turnover.
- Azure should have policies to manage the potential risks to health and safety which arise in call centres (e.g. relating to eye-strain, headaches, voice loss, tinnitus and Repetitive Strain Injury 'RSI').
- Azure's developing e-commerce business may be outsourced to a third party or managed in-house. In either case, orders and payments ('Internet bookings') need to be taken over a

secure website which should have an authentic Site stamp (e.g. 'WebTrust', 'Thawte') for immediate customer recognition and assurance.

- Increasing distribution through these emerging channels may reduce customers' demand for the traditional 'travel shop' resulting in closures of the retail travel agents. If the number of retail agents has fallen again in 2001 (having fallen from 31 in 1999 to 29 in 2000) this trend should be reflected in the analytical review of the costs and revenues associated with these outlets.

- Azure's business strategy clearly includes investment in suitable technologies which will help maintain/improve the company's market position (and returns to investors) – supporting the appropriateness of the going concern assumption as the basis for the preparation of the financial statements.
- The changes in distribution methods are a source of actual and contingent liabilities. If retail travel agents are closing, liabilities for staff redundancy costs and onerous contracts (e.g. leases on premises) may arise. Contingent liabilities may arise in respect of health and safety issues (e.g. through non-compliance with regulations or injury claims by employees).
- During the transition from retail to direct sales methods, there may be a duplication of costs (e.g. customers still want glossy brochures even though they can look at their contents on the Internet) with a consequent reduction in net margins.

(2) Internal financial control system

- The audit of Azure should be more efficient if reliance can be placed on a strong control environment (which will significantly complement specific internal controls). The control environment is likely to be assessed as strong if budgetary controls and the internal audit function are shown to be effective.
- Factors to be considered in assessing the effectiveness of budgetary controls will include:
  - the frequency and timeliness of the review of budgets against actual (monthly, quarterly?);
  - the action taken, if any, when actual is not as budgeted (e.g. spiralling costs or slump in revenue at a location).
- Factors to be considered when assessing the suitability of budgeted information for analytical procedures include:
  - the degree of disaggregation (e.g. would expect revenues and costs to be analysed between holiday location/hotel);
  - the availability of financial and non-financial data (e.g. non-financial might be expected to include air
- passengers, passenger-kilometres, room occupancies, booking cancellations, etc);
  - its relevance and reliability (e.g. if it is prepared with care).
- The precise scope of the internal audit function will need to be ascertained in planning an effective approach to the external audit of Azure. Other factors to be considered in making a preliminary assessment of the relevance and reliability of internal audit include:
  - its organisational status (appears to be high as it reports to the Audit Committee);
  - the technical competence of the team (professional qualifications, etc);
  - its exercise of due professional care (as evidenced by procedures performed and documentation thereof);
  - what action, if any, is taken by the Audit Committee on the internal audit function's findings and recommendations.

(3) Analytical procedures

The opportunity to use analytical procedures in a cost-effective audit of Azure can be demonstrated by the comparison of 2000 figures against 1999. For example:

- The 23·5% increase in turnover is attributed to the growth in direct sales. However, that the expansion is less than the increased investment in non-current assets (nearly 36%), may indicate that:
  - retail revenues are falling;

  - some of the investment (e.g. in Internet technology) has not yet reached its full revenue-generating potential
  - in which case revenues in 2001 may be expected to show a further increase.
- Although turnover increased by nearly 25%, operating PBT increased by only 6·2%. Some of the increase in operating costs could be relatively short-term (e.g. staff training and other expenses incurred in the setting up of new distribution methods). Alternatively, this could reflect longer term inefficiencies.
- Operating PBT represents just 2·9% of turnover (1999 – 3·4%). Azure's margins may be being squeezed by higher distribution costs (especially if duplicated) and increased competition.
- The Kshs.28·8m increase (35·9%) in tangible non-current assets may have been financed by the issue of convertible debt.

Tutorial note: *It is unlikely that any meaningful comparison of asset turnover can be made given that significant leased assets are off the balance sheet.*

- The Kshs.11·5m increase (63%) in trade receivables is barely material (1·2% of turnover). A crude estimate of receivable days is 11·5 (1999 – 8·7). Trade receivables does appear to be a risk area of the audit. Direct
- confirmation ('circularisation') of individual customer balances is clearly inappropriate (2m customers _ 63,000 owing money at the year end). 14 x 11·5 ——— 365
- Cash (and equivalents) has increased by 52% ($47·6m) as a result of having issued the convertible debt. The high level of cash reflects Azure's exposure to liquidity risk. In particular current liabilities have increased by Kshs36·7m (18·3%).
- The 13·8% increase in advances is less than the increase in turnover. This could be due to:
  - a fall in the level of advance bookings (e.g. as more customers wait for 'last minute' bargains);
  - Azure having relaxed its policy on the timing and/or amount of holiday deposits and advance payments (e.g. to attract bookings);
  - delays or other problems being encountered in collecting deposits on Internet bookings.
- The debt appears to have financed an increase in tangible non-current assets and increased Azure's liquidity in the short to medium-term. If the debt is converted before its redemption date, Azure will have increased its equity base and obtained finance for the longer term (e.g. to meet increasing lease commitments of more than five years).

(b) Appropriate selection criteria

Tutorial notes

This part is perhaps easier than (a) in that it does not require the same depth of analysis of the scenario. Candidates who strictly allocate their time to each part are likely to score more highly on this question overall than those who allow themselves to over-run on part (a) and produce 'sketchy' answers to (b).

The marking scheme indicates that full marks could be obtained by identifying and briefly commenting on 10 criteria or identifying and providing a more detailed commentary on just four criteria – or anything in between. This answer is indicative of the comments that could be made, it is not prescriptive.

Audit firm

'Background information' provided by the audit firms invited to tender is likely to include:

- organisation structure (e.g. into specialised departments for audit, tax, etc);
- its size (e.g. in terms of staffing levels);
- locations of offices (including overseas locations relevant to Azure);
  - affiliated firms (if any);
  - its relevant client portfolio (as an indicator of the firm's relevant experience and reputation in the travel/holiday/leisure industry). Azure may be particularly interested in the reputation of the audit firm (i.e. how highly it is regarded). For example, Azure may be seeking to improve its 'standing'/image (e.g. with its bankers or other finance providers) by association with a distinguished audit firm name.

First impressions

- Whether the submission deadline for responses was met (on a timely basis or at the last minute) – as evidence of speed of delivery (e.g. in meeting the audit reporting deadlines).
- The quality of the submission (e.g. whether it is complete, well-presented, factually correct, etc) – as evidence of the likely quality of audit work.

Understanding the business

- Azure will expect the submissions to demonstrate the experience of each of the audit firms in the travel/holiday/leisure industry (e.g. as evidenced by its relevant client portfolio). An appreciation of significant economic and legal issues in any of the countries in which Azure offers holidays would also be relevant. Azure may rank, in particular, the audit firms' understanding of Azure's business (how it works) and its objectives (future aspirations) – which must be evident in the submissions.

The audit team

Factors to consider when Azure is assessing the calibre of each of the proposed audit teams may include:

- its size (staffing levels) and mix (between grades of staff);
- its organisation (e.g. between subordinates/managers and audit/tax etc) and coordination (e.g. with clear communication channels and lines of reporting);
- the relevant experience of key individuals (audit engagement partner and managers);
- the level of partner input;
- access to relevant specialists both within the firm and external consultants (e.g. in IT).

Services

- The services of greatest interest to Azure are likely to be international tax and IT (in addition to audit). However, legal matters (e.g. relating to contracts and franchises or licences) may also be relevant. Azure is most likely to be looking for a firm with the capability to deliver the range and quality of services relevant to their immediate and future needs (for the benefits of 'onestop shopping' such as economies of scale).
- Azure may be seeking an audit firm with a proactive approach and the ability to add value to its business. For example, there may be tax or other benefits to be obtained by changing the status and/or registration of representative offices (e.g. from overseas branches to local companies or *vice versa*).

Audit approach

In having requested, as part of the submission, 'principal audit risks … other planning issues … audit strategy', Azure will expect the firms to have demonstrated, for example:

- a high level of planning
- an understanding of audit issues (and how these issues will be reported to Azure)
- an audit methodology offering a cost effective approach.

Tax

Submissions will be expected to show an understanding of tax issues (e.g. in relation to overseas operations) and proactivity in providing practical, cost-effective solutions.

Chemistry

Although personal rapport and the audit firm's enthusiasm for a working relationship with Azure will be more apparent at the presentation stage, Azure will make some assessment about 'chemistry' before then. Azure will be asking 'Do they understand our business issues?' and if, for example, Azure met with any of the firms before the submission 'Does the submission show that they listened to us?'.

Fees

- Azure will expect competitive fees/value for money/constructive business advice.
- A fee breakdown (e.g. split between grades of staff and/or audit and tax compliance work) will probably have been requested to facilitate comparison between the firms.
- Azure may be suspicious of (have reservations about) an audit fee proposed by a tenderer if it is significantly lower ('lowballing'?) or higher than others.

Other criteria
Whilst there is no suggestion that Azure is seeking 'malleable' (i.e. acquiescent) auditors, Azure is unlikely to invite to the presentation stage any firm whose submission shows a lack of empathy for the organisation's business objectives, risk management policies, etc.
Tutorial note: *Whilst 'nepotism' may be a factor considered in the selection of auditors or advisors, it is not one that should* be used in the 'evaluation of submissions received'.

QUESTION FOUR

Computerised systems present an auditor with problems but also with opportunities. Computer Assisted Audit Techniques (CAAT's) have been developed to overcome some of the problems and to grasp some of the opportunities, the two principal techniques are:-

i. use of test data to test the operation of the clients programs

ii. use of audit software - computer programs developed for audit purposes to examine the contents and do the work on the contents of the client's computer files.

A problem arises in the use of test packs in that there is a choice. The test pack can be used together with live input to test the effect of live programs, carrying out the test during normal processing using live master files. The alternative is to use copy, test or dummy master files. The choice is between live testing and dead testing.

(a) LIVE TESTING HAS THE FOLLOWING ADVANTAGES

i. If the data is included with normal data, separate test data totals cannot be obtained. This can sometimes be resolved by the use of dummy branches or separate codes to report the program's effect on the test data.

ii. Side effects can occur. It has been known for an auditor's dummy product to be included in a catalogue.

iii. Client's files and totals are corrupted although this is unlikely to be material.

iv. If the auditor is testing procedures such as debt follow up, then the testing has to be over a long period of time. This can be difficult to organise.

(b) DEAD TESTING HAS THE FOLLOWING DISADVANTAGES

i. Difficulties will be encountered in simulating a whole system or even a part of it.

ii. A more detailed knowledge of the system is required than with the use of live files.

4 (b) Control Over Input

Control techniques for ensuring for completeness on input in a timely fashion include:-

(a) manual or programmed agreement of control totals
(b) one for one checking of processed output to source documents
(c) programmed matching of input to a control file, containing details of expected input
(d) manual or programmed sequence checking
(e) procedures over resubmission of rejected controls

Controls over the accuracy of input are concerned with the data fields on input transactions. Control should be exercised not only over value fields, such as invoice amounts, but also important reference fields, such as account number or data of payment. Some of the techniques control accuracy but others, such as sequence checks, will not. Additional techniques to ensure accuracy include:

(a) Programmed check digit verification (a check digit included in a reference number is arithmetically checked to ensure that it bears the required relationship to the rest of the number).
(b) Programmed reasonableness checks, including checking the logical relationship between two or more files.
(c) Programmed existence checks against valid codes
(d) Manual scrutiny of output

Controls over authorization involve checking that all transactions are authorised and that the individual who authorised each transaction was so empowered. This will generally involve a clerical review of input transactions, although a programmed check to detect transactions that exceed authorization limits may be possible. The clerical review should be done either after a control total has been established or after processing, to ensure that unauthorised transactions cannot be introduced after the review.

(i). There is often uncertainty as to whether operational programs are really being used for the test.
(ii). The technique uses a lot of computer time which may upset the client's schedules.
(iii). The time span problems is still difficult but more capable of resolution than with live testing.

(b) Computer Audit Programs

i. These consist of computer programs used by an auditor to

1. read magnetic files (disks or tapes) and to extract specified information from the files

2. carry out audit work on the contents of the file

ii. These programs are sometimes known as enquiry or interrogation programs. They are usually written in high level languages such as Cobol. They are usually written by or for an audit firm and such programs are also available from software houses.

iii. Staff unskilled in programming can be easily taught to put their search or operating requirements into a simple coded form which the computer audit program can interpret and apply to the files selected.

iv. Disadvantages

1. can be expensive to set up or acquire

2. some technical knowledge is required

3. a variety of programming is used in business. Standard computer audit programs may not be compatible.

4. Detailed knowledge of systems and programs is required. Some auditors would dispute the need for this detailed knowledge to be gained.

5. Difficulty in obtaining computer time especially for testing.

v. There can be no doubt that standard computer audit program packages will be in general use in the near future.
vi. Use of audit software raises the visibility of the auditor in the eyes of the company. It makes the audit more credible.
vii. Interesting `quirks' in the system are often discovered and can be reported to management. This also makes the audit more credible.
viii. Packages are not usually available for small machines.

QUESTION FIVE

6 (a) Development, role, and authority of ISAs

(i) ISAs set out the basic principles and essential procedures that auditors should follow in the conduct of an audit of financial statements.
(ii) Auditing Standards are in bold type. The grey type found in ISAs provides guidance on the application of ISAs.
(iii) International Standards on Auditing are set by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). The IAPC is made up of representatives of the profession who are members of IFAC.
(iv) ISAs and other documents issued by the IAPC are developed using a process of exposure and consultation in order to obtain consensus and wide-spread acceptance of standards. Consultation is with interested parties outside the profession, as well as within the profession itself.
(v) ISAs apply to all audits of financial statements that are expressed in true and fair, fair presentation, or similar terms.
(vi) ISAs are developed with due regard for developments in national standards as described in (c) below.

(b) The role of the ICPAK in the regulation of auditors

(i) Auditors are regulated differently in different countries. In some countries governments regulate auditors directly, or through government organisations. In other countries the profession is self-regulating. In most cases, there is some combination of self-regulation and government regulation.
(ii) The professional bodies regulating auditors in the Kenya include the ICPAK. There is a strong tradition of self-regulation in the Kenya which is not the case in, for example, certain European countries where government regulation is more direct.
(iii) Professional bodies such as the ICPAK, like other regulators, seek to uphold professional standards, to investigate complaints against auditors, and to assist auditors in the performance of their duties. They have both investigative powers and sanctions against auditors who do not comply with professional standards. These include fines, exclusion from membership, and the withdrawal of the licence to audit (audit registration). Members of the ICPAK are bound by its Rules of Professional Conduct.
(iv) The ICPAK encourages high professional standards by setting academic requirements for those wishing to study for the examinations, by setting the examinations and by requiring additional experience of those who wish to practice as auditors.

(c) How ISAs and national standards influence each other

(i) In a global market-place it is increasingly important that Auditing Standards are harmonised across the world, particularly for multinational companies. It is also important that Auditing Standards are applied consistently. Over the last ten years, standard setters in those countries where the profession is mature have sought to harmonise their own standards with International Standards, and to influence International Standards.

(ii) In many countries, all new national Auditing Standards contain a statement to the effect that compliance with the national standard will ensure compliance with the relevant International Standard in all material respects, if that is the case, or it will explain the difference(s).

(iii) It is not always possible for local Auditing Standards to be the same as International Standards because of local legal requirements. Nevertheless, a number of countries have accepted International Standards in their entirety, or have accepted them subject to some minor local variations. International Standards are thus extremely useful for countries where the profession is not strong and where government does not seek to detail Auditing Standards, and where there are few resources to develop local standards.

(iv) Standard setters in countries where the profession is mature make a significant contribution to the development of ISAs by providing representatives to sit on IFAC Committees and working parties and by providing the resource to help draft standards. National standard setters comment on consultation papers and exposure drafts issued by the IAPC and help summarise responses on certain projects.

(v) ISAs only have force internationally if they have the support of those countries who lead the profession internationally. It is therefore essential for both national standard setters and international standard setters to take account of each others work.

PART IV: REVISION QUESTIONS AND ANSWERS

QUESTIONS

This section has twenty questions and answers.

QUESTION ONE

The principal activity of Bateleur Zoo Gardens (BZG) is the conservation of animals. approximately 80% of the zoo's income comes from admission fees, money spent in the food and retail outlets and animal sponsorship. The remainder comprises donations and investment income.
Admission fees include day visitor entrance fees ('gate') and annual membership fees. Day tickets may be pre-booked by credit card using a telephone booking 'hotline' and via the zoo's website. Reduced fees are available (e.g. to students, senior citizens and families).
Animal sponsorships, which last for one year, make a significant contribution to the cost of specialist diets, enclosure maintenance and veterinary care. Animal sponsors benefit from the advertisement of their names at the sponsored animal's enclosure.
BZG's management has identified the following applicable risks that require further consideration and are to be actively managed:

(i) Reduction in admission income through failure to invest in new exhibits and breeding programs to attract visitors;
(ii) Animal sponsorships may not be invoiced due to incomplete data transfer between the sponsoring and invoicing departments;
(iii) Corporate sponsorships may not be charged for at approved rates – either in error or due to arrangements with the companies. In particular, the sponsoring department may not notify the invoicing department of reciprocal arrangements, whereby sponsoring companies provide BZG with advertising (e.g. in company magazines and annual reports);
(iv) Cash received at the entrance gate ticket offices ('kiosks') may not be passed to cashiers in the accounts department (e.g. through theft);
(v) The ticket booking and issuing system may not be available;
(vi) Donations of animals to the collection (e.g. from Customs and Excise seizures and rare breeds enthusiasts) may not be recorded.

Required:
(a) Describe suitable internal controls to manage each of the applicable risks identified. (12 marks)
(b) Explain the financial statement risks arising from the applicable risks. (6 marks)
(c) Comment on the factors to be considered when planning the extent of substantive analytical procedures to be performed on BZG's income. (7 marks)
(Total: 25 marks)

QUESTION TWO

Harrier Motors deals in motor vehicles, sells spare parts, provides after-sales servicing and undertakes car body repairs. During the financial year to 30 June 2004, the company expanded its operations from five to eight sites.
Each site has a car showroom, service workshop and parts storage.
In May 2004, management appointed an experienced chartered certified accountant to set up an internal audit department.

New cars are imported, on consignment, every three months from one supplier. Harrier pays the purchase price of the cars, plus 3%, three months after taking delivery. Harrier does not return unsold cars, although it has a legal right to do so.
Harrier offers 'trade-ins' (i.e. part-exchange) on all sales of new and used cars. New car sales carry a three year manufacturer's warranty and used cars carry a six-month guarantee. Many used cars are sold for cash.
An extensive range of spare parts is held for which perpetual inventory records are kept. Storekeepers carry out continuous checking.
Mr Joop, the sales executive, selects a car from each consignment to use for all his business and personal traveling until the next consignment is received. Such cars are sold at a discount as ex-demonstration models.
Car servicing and body repairs are carried out in workshops by employed and sub-contracted service engineers. Most jobs are started and finished in a day and are invoiced immediately on completion.
In May 2003 Harrier purchased a brand name, 'Uni-fit', which is now applied to the parts which it supplies.
Management has not amortised this intangible asset as it believes its useful life to be indefinite.

Required:

(a) Using the information provided, identify and explain the audit risks to be addressed when planning the final audit of Harrier Motors for the year ending 30 June 2004. (12 marks)
(b) Identify and briefly explain the principal matters to be addressed in Harrier Motors' instructions for the conduct of its physical inventory count as at 30 June 2004. (6 marks)
(c) Describe the audit work to be carried out in respect of the useful life of the 'Uni-fit' brand name as at 30 June 2004. (7 marks)

(Total: 25 marks)

QUESTION THREE

You are the manager responsible for the audit of Eagle Energy, an energy generation company. The draft financial statements for the year ended 31 March 2004 show revenue of Shs.287 million (2003 – Shs.262 million), profit before taxation of Shs.7·2 million (2003 – Shs.23 million) and total assets of Shs.242 million (2003 – Shs.221 million).
The following issues arising during the final audit have been noted on a schedule of points for your attention:

(a) During the year Eagle Energy put its technical staff through a new training program. On the basis that this expenditure has been incurred solely for the purpose of generating future economic benefits the chief executive is adamant that the costs, amounting to Shs.4·3 million, be capitalised as an intangible asset. (7 marks)
(b) During the year Eagle Energy assembled a laboratory on land which had been granted to it for 25 years, by the local authority, in 1995. Under the terms of the grant the laboratory must be dismantled and the site decontaminated when the grant term expires. This is expected to cost Shs.18 million in 2020 and an annual provision of Shs.1·2 million is being made. (7 marks)
(c) Eagle Energy receives significant funding from government sources and is required to report, monthly, on its financial performance and position. Every month end a journal entry is made, 'Debit Sundry 1 account/Credit Sundry 2 account'. There is no narrative but the chief accountant explained that the journal is approved by the chief executive to ensure that reported debt ratios stay within government specified limits. The entries are then reversed at the beginning of the following month. The net movement on these accounts over the year to 31 March 2004 was Shs.0·3 million. (6 marks)

Required:

For each of the above issues:
i) comment on the matters that you should consider; and

ii) state the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Eagle Energy for the year ended 31 March 2004. **(Total: 20 marks)**

Note: The mark allocation is shown against each of the three issues.

QUESTION FOUR

(a) Explain why quality control may be difficult to implement in a smaller audit firm and illustrate how such difficulties may be overcome. (5 marks)

(b) Kite Associates is an association of small accounting practices. One of the benefits of membership is improved quality control through a peer review system. Whilst reviewing a sample of auditor's reports issued by Rook & Co, a firm only recently admitted to Kite Associates, you come across the following qualified opinion on the financial statements of Lammergeier Group:

'Qualified opinion arising from disagreement about accounting treatment relating to the non-adoption of IAS

'The management has not prepared a group cashflow statement and its associated notes. In the opinion of the management it is not practical to prepare a group cashflow statement due to the complexity involved. In our opinion the reasons for the departure from IAS 7 are sound and acceptable and adequate disclosure has been made concerning the departure from IAS 7. The departure in our opinion does not impact on the truth and fairness of the financial statements.

'In our opinion, except for the non-preparation of the group cashflow statement and associated notes, the financial statements give a true and fair view of the financial position of the Company as at 31 December 2003 and of the profit of the group for the year then ended, and have been properly prepared in accordance with …'

Your review of the prior year auditor's report has revealed that the 2002 year-end audit opinion was identical.

Required:

Critically appraise the appropriateness of the audit opinion given by Rook & Co on the financial statements of Lammergeier Group for the years ended 31 December 2003 and 2002. (10 marks)

(Total 15 marks)

QUESTION FIVE

You are a training manager in Hawk Associates, a firm of Chartered Certified Accountants. The firm has suffered a reduction in fee income due to increasing restrictions on the provision of non-audit services to audit clients. The following proposals for obtaining professional work are to be discussed at a forthcoming in-house seminar:

(a) 'Cold calling' (i.e. approaching directly to seek new business) the chief executive officers of local businesses and offering them free second opinions. (5 marks)

(b) Placing an advertisement in a national accountancy magazine that includes the following: 'If you have an asset on which a large chargeable gain is expected to arise when you dispose of it, you should be interested in the best tax planning advice. However your gains might arise, there are techniques you can apply. Hawk Associates can ensure that you consider all the alternative fact presentations so that you minimise the amount of tax you might have to pay. No tax saving – no fee!' (6 marks)

(c) Displaying business cards alongside those of local tradesmen and service providers in supermarkets and libraries.

The cards would read:

'Hawk ACCA Associates
For PROFESSIONAL Accountancy, Audit,
Business Consultancy and Taxation Services

Competitive rates. Money back guarantees.' (4 marks)

Required:

Comment on the suitability of each of the above proposals in terms of the ethical and other professional issues that they raise. **(Total: 15 marks)**
NOTE: The mark allocation is shown against each of the three issues.

QUESTION SIX
6 International Standard on Auditing ISA 240 'The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements' distinguishes fraud from error, sets out the auditor's responsibilities with respect to fraud, and provides additional guidance related to earnings management.

Required:
i) Compare and contrast the auditor's responsibility for the detection and reporting of fraud and of error. Your answer should distinguish fraud from error. (5 marks)
ii) Explain the term 'professional skepticism' and comment on its role in the detection of fraud. (5 marks)
iii) Comment on the difficulties which 'earnings management' present to the auditor. (5 marks)
(Total: 15 marks)

QUESTION SEVEN
PRACTICE ORGANISATION CHOICE
With the creation of new limited liability partnerships auditors now have a choice of vehicle to deliver audit services. Explain the advantages and disadvantages of:
(a) Partnerships (5 marks)
(b) Limited liability partnerships and (5 marks)
(c) Incorporated audit firms (5 marks)
(Total: 20 marks)

QUESTION EIGHT
EXPECTATION GAP
The following statement has been made about the 'audit expectation gap' and the means of solving the problem.

'Following the Caparo decision, auditors of large companies have no responsibility to ensure that the accounts they audit are accurate, and they are not required to detect and report on error and fraud.

Recent failures of companies and major frauds in financial institutions and pension funds indicate serious weaknesses in the quality of audits. What is required is that auditors should have responsibility:
(a) to a larger range of parties than those decided in the Caparo case (7 marks)
(b) for detecting and reporting all error and fraud, and (5 marks)
(c) for institutions holding and investing client's money and pension funds, auditors should be present at all times to ensure that no loss arises from investing these funds and that fraud is prevented (8 marks)

If necessary, there should be change in legislation to implement these proposals.'

You are required to discuss this statement, particularly the matters noted in parts (a) to (c). Your answer should consider the practicality of implementing these proposals, and, if you believe they are impractical, you should make proposals which should be acceptable to both the general public and auditors. **(Total: 20 marks)**

QUESTION NINE
BECHER CONSTRUCTION

Becher are a major independent construction company, dealing with large scale contracts throughout Kenya and with some international interest in Africa, particularly in Uganda. Becher have recently established an audit committee whose members are very concerned about meeting corporate governance 'best practice', particularly since they are currently looking at obtaining a stock exchange listing. You are an internal auditor with the company and have been asked to conduct a review of how well the company are meeting requirements.

You are required to prepare a report that addresses:

(a) What is corporate governance and why are corporate governance requirements important? (4 marks)

(b) What are the key issues for Becher to address to achieve effective corporate governance? (5 marks)

(c) What is the role of internal audit in achieving corporate governance compliance? (4 marks)

(d) What should the role of the audit committee be in demonstrating corporate governance (4 marks)

(e) List the types of regular reporting that would be useful for Becher (3 marks)

(Total: 20 marks)

QUESTION TEN
MT INVESTMENTS

MT is an investment company, regulated by the Capital Market Authority.
There is a small internal audit department, focusing primarily on financial audits. Your firm provides external audit services and have been asked to bid to provide internal audit and review services to MT, either on a partnership basis with the existing team or taking over the function completely.

(a) You have been asked to prepare a report showing the key factors to be considered in making the decision on outsourced services, in particular:
- High level planning
- Risk based approach
- Methodology
- Management information and reporting
- Corporate governance

(b) Describe the issues that your firm might face in the provision of internal audit services, in particular ethical concerns and how these could be addressed (4 marks)

(c) Explain the advantages and disadvantages of outsourcing of internal audit services. (6 marks)

(Total: 20 marks)

QUESTION ELEVEN
ISTHMUS PLC

You are an audit manager of Kloser, a firm of Chartered Certified Accountants. You are assigning staff to the final audit of Isthmus plc for the year to 31 December 2002. You are aware of the following matters:

1. Isthmus has recently issued a profit warning. The company has announced that the significant synergies expected from the acquisition of Vanaka, a former competitor company, have not materialized. Moreover, it has emerged that certain Vanaka's assets are significantly impaired. Your firm's corporate finance department, assisted by two audit trainees, carried out due diligence work on behalf of Isthmus before the purchase of vanaka was completed in December 2001.

2. Mercedes, the assistant manager assigned the interim audit of Isthmus, has since inherited 5,000 shares in Isthmus. Mercedes has told you that she has no intention of selling the share until the share price recovers from the fall of 1.95 which followed the profit warning.

3. Anthony, the audit senior, has been assigned to the audits of Isthmus since joining the firm nearly three years ago. He has confided to you that his father owned 1,001 shares in Isthmus but sold them only days before the profits warning at a share price of 7.95. You are assured that Anthony did not previously know that his father had the shares.

Required:
Comment on the ethical and other professional issues raised by the above matters and their implications, if any, for staffing the final audit of Isthmus for the year to 31 December 2002.

(Total: 15 marks)

QUESTION TWELVE
GAIS

GAIS operate in the competitive environment of auditing, accounting and knowledge management and have been looking at ways of being more efficient, economic and effective as well as demonstrating achievement of best practice to demonstrate leading edge delivery. The consultancy of GAIS undertook a high level review of current working practices across the organization and came up with a number of findings:

- GAIS are not leveraging IT in the performance of their responsibilities with minimum automation of activities and low level computer use
- There are no quality control mechanisms
- Working papers are inconsistent and incomplete

You are employed by the auditing section of GAIS and have been asked to come up with a paper setting out proposals for addressing these findings within the audit team.

You are required to prepare a paper with the following details:

(a) Explain the benefits of the use of information technology and recommend ways that GAIS can best use automation in their auditing services (10 marks)
(b) Describe the importance of quality control and propose a quality control strategy and procedures that should be implemented within GAIS (10 marks)
(c) Explain the risks of inadequate working papers and describe the criteria that should be implemented by GAIS for working papers to address such risks (5 marks)

(Total: 25 marks)

QUESTION THIRTEEN
PHONES ANYWHERE

You are the partner in charge of a four partner firm of Certified Accountants. Your firm has been invited to tender for the audit of Phones Anywhere Limited for the year ended 31 December 20x7.

Phones Anywhere Ltd. was established two year ago, and it provides a mobile phone service for individuals and businesses. The system being established by the company comprises:

(a) Small portable mobile phones, which allow subscribers (users) to contact or be contacted by any other telephone
(b) The mobile phones can be used within a range of a local relay station, which receives calls from and sends calls to the mobile phones
(c) The local relay stations are linked to a central computer which connects the calls to other users. Frequently, this is through a competitor's telephone network.
(d) Currently, the local relay stations cover one large city with a population of about 1,000,000. Within the next year the system will cover all large cities in the UK with a

population of over 250,000. By the year 20Y0, the system will cover all motorways and cities with a population of over 100,000. Extending the coverage of the system will involve considerable capital expenditure on new relay stations and require additional borrowings.

(e) The cost of the relay stations and central computer are capitalized and are written off over six years

(f) The mobile phones are manufactured by other companies and sold through retailers. Phones Anywhere dies not sell the phones, but it pays 200 to a retailer for each phone sold and subscription signed by the customer to Phones Anywhere. This payment is capitalized in the financial statements of Phones Anywhere and written off over four years.

(g) Subscribers are invoiced monthly with a fixed line rental and a variable call charge. Other operators are charged for the time spent by their customers contacting Phones Anywhere's subscribers (customers). These charges are logged and calculated by the company's main computer.

(h) All the shares are owned by three wealthy individuals who are non-executive directors. They will receive a fixed salary. They do not plan to make any further investment in the company.

(i) Establishing the network of relay stations and subscribers will result in the company making losses for at least three years. Current borrowing are about 20% of shareholders' funds. Because of the substantial capital expenditure and trading losses it is expected the company will be highly geared by the year 20Y0.

(j) As the company will not be profitable, the non-executive directors have decided that executive directors should receive basic salary and a bonus based on the number of subscribers to the system.

(k) The owners plan to float the company on the London Stock Exchange in the year 20Y0.

The flotation will involve:

(i) issuing new shares to the general public to provide funds for the company, and
(ii) the three non-executive directors selling some of their shares

You are aware that Phones Anywhere has a number of very large competitors, each of which has a large number of users and comprehensive coverage (i.e. over 90% of the population are within range of a relay station).

You are required, in relation to the audit of Phones Anywhere

(a) Consider the risks associated with the audit (10 marks)

(b) Describe the ethical matters you should consider in deciding whether your audit firm should accept the audit. This should include considering whether your firm has the technical and logistical ability to carry out the audit (10 marks)

(c) Come to a conclusion on whether you would advise your firm to accept or decline the audit, giving your principal reasons for coming to this decision (5 marks)

(Total: 25 marks)

QUESTION FOURTEEN

REGULATION AND PROFESSIONALISM

The auditing profession has been criticized recently by politicians for its role in monitoring potential corporate failure. Radical reforms have been called for in the way the audit is regulated. For example, politicians have stated that there should be a change of legislation in the following ways:

(i) Auditing standards

Auditing standards should be set and enforced independently from the accounting profession

(ii) Fraud
Auditing firms should have a duty to detect and report fraud
(iii) Non audit services
Non auditing services supplied to an audit client should be stopped
(iv) The duration of the appointment of auditors
The appointment of auditors should be for a maximum of seven years

Required:

(a) Describe the current regulatory and professional requirements relating to each of the main headings listed above. (12 marks)
(b) Discuss the reasons why you feel that the audit profession has been criticized over the current regulations in the above areas (8 marks)

(Total: 20 marks)

QUESTION FIFTEEN

Knowledge of the business is crucial to determining the most effective and efficient audit strategy for an entity using the Internet for electronic commerce. Any auditor needs to have an in-depth understanding of the related risks and the security measures to minimiSe them.'

Required:

Discuss the impact of e-commerce on the audit process. **(Total: 15 marks)**

QUESTION SIXTEEN

Your audit client, Alakazam, sells and distributes telecommunications equipment and accessories to retail outlets. The company has expanded rapidly since the appointment of a new chief executive, Leon Izzardo, in September 2000.

In October 2000, the company purchased exclusive national distribution rights to an imported WAP phone for a two year period. During 2001, the company has doubled its customer base and is close to achieving national coverage with ts distribution network. Employee numbers have increased rapidly from 36 to 103. Head office administrators, including accounts staff, have risen from 10 to 25.

In October 2001, the central distribution and servicing department was moved away from the head office into larger premises. This was necessary to handle not only the increased inventory levels and pre-delivery checks necessary, but also the rising level of after sales warranty work caused by manufacturing defects in the WAP phones. Sales of the WAP phone, which now account for 80% of Alakazam.s turnover, have recently started to fall. You have been assigned the task of planning the audit of the financial statements of Alakazam for the year ended 31 March 2002.

Required:

a) Describe the principal audit risks arising and how the audit strategy will be directed to take account of them inthe overall audit plan. (14 marks)
b) Mr Izzardo has now targeted Neodex, a private limited company, for acquisition by Alakazam in early 2002. Your firm has just completed a review of Neodex.s published financial statements for the year to 31 December 2000 and held brief discussions with its two directors. The main findings were as follows:
    1) Shares in Neodex are owned equally by the technical director, Stefan Koyla, and marketing director, Georgio Neratu, who set up the company three years after graduating from university.

2) Neodex has successfully developed a small range of specialised data interface network servers (DINS) which significantly reduce the costs of communication systems. Each unit sells for Kshs.3,500 . Kshs.5,000. Monthly sales are increasing slowly but steadily since Georgio presented the products at an IT exhibition earlier this year.
3) Between them, Stefan and Georgio assemble and package DINS in a small rented office. The manufacture and assembly of the principal component (a circuit board) is outsourced. Stefan would like to recruit an assistant so that he has time to prototype his new design for the Virtual Private Network (VPN) market.
4) Neodex has only one employee who acts as telephonist, receptionist, secretary and bookkeeper.

Required:
(i) Outline the principal matters to be considered by Alakazam in deciding whether or not to acquire Neodex. (5 marks)
(ii) Explain the implications of the acquisition for the conduct of your audit of Alakazam for the year to 31 March 2002. (6 marks)
(Total: 25 marks)

QUESTION SEVENTEEN

You are the manager responsible for the audit of Siegler, a limited liability company. Siegler develops products and technologies for the life sciences industry. The draft accounts for the year ended 30 June 2002 show profit before taxation of Kshs.4·6 million (2001 – Kshs.4·2 million) and total assets Kshs.46·3 million (2001 – Kshs.41·7 million).

The following issues are outstanding and have been left for your attention:

(1) A government grant of Kshs.800,000 was received in May 2002 to assist in operating a new pilot plant that will use Siegler's patented bio-technology. The amount of the grant has been deducted from bio-technology development costs that are included in intangible assets with a carrying value of Kshs.4·5 million. In October 2002, Siegler's order for specialist equipment, which was to have been used in the pilot plant, was cancelled. A recent board minute shows that the company's research activities are to be focused on a new 'smart-drug' technology. (8 marks)

(2) Siegler closed and demolished one of its laboratories four years ago. The land on which it stood has not been used since and is carried at a cost of Kshs.72,000. Results of tests by the local water authority published in July 2002 show that the site is contaminated with hexavalent chromium, which is known to be toxic. Although there is currently no legislation requiring Siegler to clean up the site, a provision for $1 million has been made in the financial statements for the year ended 30 June 2002. (6 marks)

(3) Siegler owns two properties as well as its laboratories, production facilities and head office. One property is a residential apartment block and the other an office block. The apartments are leased out on an annual basis and are currently fully let. However, many of the offices are vacant and available for let on monthly as well as annual terms. On 30 June 2002, the apartment block was valued at an open market value that was Kshs.3·3m in excess of its carrying amount under the benchmark treatment of IAS 16 'Property, Plant and Equipment' (i.e. at cost less accumulated depreciation). This excess has been credited to a revaluation reserve. (6 marks)

Required:
For each of the above issues:
(a) comment on the matters that you should consider; and

(b) state the audit evidence that you should expect to find,
in undertaking your review of the audit working papers and financial statements of Siegler.

(Total: 20 marks)

NOTE: The mark allocation is shown against each of the three issues.

QUESTION EIGHTEEN

You are the manager responsible for the audit of Visean, a limited liability company, which manufactures health and beauty products and distributes them through a chain of 72 retail pharmacies. The draft accounts for the year ended 31 December 2001 show profit before taxation of Kshs.1·83 million (2000 – Kshs.1·24 million) and total assets Kshs.18·4 million (2000 – Kshs.12·7 million).

The following issues are outstanding and have been left for your attention:

(1) Visean owns nine brand names of fragrances used for ranges of products (e.g. perfumes, bath oils, soaps, etc), four of which were purchased and five self-created. Purchased brands are recognised as an intangible asset at cost amounting to Kshs.589,000 and amortised on a straight-line basis over 10 years. The costs of generating self-created brands and maintaining existing ones are recognised as an expense when incurred. Demand for products of one of the purchased fragrances, 'Ulexite', fell significantly in January 2002 after a marketing campaign in December caused offence to customers. (8 marks)

(2) In December 2001 the directors announced plans to discontinue the range of medical consumables supplied to hospital pharmacies. The factory manufacturing these products closed in January 2002. A provision of Kshs.800,000 has been made as at 31 December 2001 for the compensation of redundant employees and a further Kshs.450,000 for the three years unexpired lease term on the factory premises. (7 marks)

(3) Historically the company's cash flow statement has reported net cash flows from operating activities under the 'indirect method'. However, the cash flow statement for the year ended 31 December 2001 reports net cash flows under the 'direct method' and the corresponding figures have been restated. (5 marks)

Required:

For each of the above issues:

(i) comment on the matters that you should consider; and

(ii) state the audit evidence that you should expect to find,
in undertaking your review of the audit working papers and financial statements of Visean.

(Total: 20 marks)

NOTE: The mark allocation is shown against each of the three issues.

QUESTION NINETEEN

Aventura International, a listed company, manufactures and wholesales a wide variety of products including fashion clothes and audio-video equipment. The company is audited by Voest, a firm of Chartered Certified Accountants, and the audit manager is Darius Harken. The following matters have arisen during the audit of the group.s financial statements for the year to 30 June 2001 which is nearing completion:

(1) During the annual physical count of fashion clothes at the company.s principal warehouse, the audit staff attending the count were invited to purchase any items of clothing or equipment at 30% of their recommended retail prices.

(2) The chief executive of Aventura International, Armando Thyolo, owns a private jet. Armando invoices the company, on a monthly basis, for that proportion of the operating costs which reflects business use. One of these invoices shows that Darius Harken was flown to Florida in September 2000 and flown back two weeks later. Neither Aventura nor Voest have any offices or associates in Florida.

(3) Last week Armando announced his engagement to be married to his personal assistant, Kirsten Fennimore. Before joining Aventura in March 2001, Kirsten had been Voest.s accountant in charge of the audit of Aventura.

Required:
Discuss the ethical issues raised and the actions which might be taken by the auditor in relation to these matters. **(Total: 15 marks)**

QUESTION TWENTY

(a) Explain the auditor's responsibilities for reporting on compliance with International Financial Reporting Standards (IFRSs) when the financial statements state that they are prepared in accordance with:
   i) only IFRSs;
   ii) both IFRSs and relevant national standards or practices; and
   iii) relevant national standards or practices, but which disclose in the notes to the financial statements the extent of compliance with IFRSs. (5 marks)

(b) You are the engagement partner to Frazil, a private limited liability company. Frazil's financial statements for the year ended 30 September 2003, show total assets Kshs.107 million and profit before tax Kshs.8·2 million. The following matters require your consideration:
   i) The basis of accounting note states that the financial statements have been prepared in compliance with International Financial Reporting Standards. However, the accounting policy note for development costs states that all development costs are expensed as incurred. Results of audit tests showed that of the Kshs.3·7 million development costs expensed during the year, Kshs.1·4 million should have been recognised as an asset in accordance with IAS 38 'Intangible Assets'.
   ii) The management of Frazil has just informed you that, for the first time, the annual report is to be published on the company's website.

Required:
Identify and comment on the implications of the above matters for your auditor's report on the financial statements of Frazil for the year ended 30 September 2003**.** (10 marks)
(Total: 15 marks)

PART IV: REVISION QUESTIONS AND ANSWERS

ANSWERS

Tutorial note: *These model answers are considerably longer and more detailed than would be expected from any candidate in the examination. They should be used as a guide to the form, style and technical standard (but not length) of answer that candidates should aim to achieve. However, these answers may not include all valid points mentioned by a candidate – credit will be given to candidates mentioning such points.*

ANSWER ONE

1 BATELEUR ZOO GARDENS

(a) Internal controls

Tutorial note: *Remember that not all controls are preventive. Some should detect (so as to correct) things that have 'gone wrong'.*

(i) Lack of investment

- Monthly review and monitoring of:
  - admission fees;
  - number of day visitors;
  - annual memberships taken out (analysed between new and renewed);
  - lapsed membership;
  - sponsorship waiting lists (animals without sponsors and sponsors waiting for suitable animals).
- Approval of annual budgets which plan for adequate investment to attract visitors.
- Monthly comparison of actual expenditure on new exhibits and breeding programs against budget – to see the extent to which the expected level of investment in development is being made.

(ii) Incomplete data transfer

- Monthly reconciliations of actual (invoiced) sponsorship income to that expected (based on number of sponsorships, by type, per sponsor department records) and investigation of shortfalls.
- Monitoring of instances of incomplete/inaccurate data transfer – how identified, reason for occurrence, amounts involved, how rectified.

(iii) Non-charges

- Monitoring of sponsorship income generated (i.e. actual) to that available (e.g. projected), by class of animal, and investigation of shortfalls.
- Comparison of BZG's advertising expenditure against budget (to identify potential for unrecorded costs).

(iv) Misappropriated cash

- Two people could 'man' each ticket kiosk at all times. A duty log should be kept (date, time, staff member).
- The kiosks must not be left unattended while cash is held there.

- All cash received from visitors should be counted and recorded and a receipt given.
- Cash and a copy of the receipts should be transferred, securely, to cashiers.
- The existence of CCTV at the kiosks should be made evident, to act as a deterrent.
- Daily reconciliation of cash takings to 'gate' (i.e. number of day visitors) and investigation of any apparent shortfall.
- A separate admission gate after the kiosk checks that entrants have been issued a ticket.
- An auditable cash register system to control cash drawers at ticket booths. Transactions must be traceable in multiple forms of tender (cash, credit card).
- Multiple cash drawer inserts enabling quick and easy shift changes. An automated audit trail of all movements in and out of each drawer.

(v) Systems not available

- Back up/recovery/contingency plans must be in place to ensure that BZG can take bookings and issue tickets even when the electronic system is not available.
- In particular, the back up system should be tested periodically to ensure that credit card bookings can be taken and correct discounts processed for concessionary tickets and group bookings.
- Preventive arrangements to ensure that any 'down time' is kept to a minimum. For example, acquiring highly reliable systems components and frequent housekeeping/maintenance.

(vi) Unrecorded donations

- Periodic inspection of animals and comparison with book records (e.g. fixed asset register for larger species and inventory records for smaller species).
- Comparing new animals identified by veterinary records to additions to inventory records (or asset register).

(b) Financial statement risks

Tutorial note: *The numbering in this answer corresponds to the applicable risks in the question.*

i) A going concern ('failure') risk arises from lack of investment. Any significant doubts about going concern must be suitably disclosed in the notes to the financial statements. Disclosure risk arises if the requirements of IAS 1 'Presentation of Financial Statements' are not met.

ii) A reduction in admission income may result in asset impairment. BZG's management should perform impairment tests on the carrying amount of the larger exhibits, in accordance with IAS 36 'Impairment of Assets'.

iii) Income may be materially understated due to:
   i. incomplete data transfer resulting in invoices not being raised;
   ii. unrecorded sponsorships arising from advertising arrangements.

Tutorial note: *It is unlikely that income would be overstated as companies would dispute the rates if they were overcharged for sponsorships.*

iv) BZG's advertising costs will be understated if their barter for sponsorships is not recorded. If material, there is a risk of non-compliance with financial reporting requirements (SIC 31 'Revenue – Barter Transactions Involving Advertising Services').

v) Cash asset/admission income will be understated in respect of cash which does not reach the accounts department. If some of this cash is not stolen but rather appropriated for use in the business (e.g. in meeting day-to-day cash expenses)

then costs would be understated also. The financial statement risk is greater if income is 'lost' through unticketed entry (as it will be more difficult to quantify than if misappropriation occurs after tickets have been issued).

vi) There may be no financial statement risk. For example, if BZG were to admit people for free there would be no admission fees to be recorded for that day. Alternatively, in the absence of an adequate back up system, the risk of unrecorded cash/income identified in (iv) may be exacerbated.

vii) Assets (and reserves) will be understated if donated animals are not initially recognised at fair value (IAS 16 'Property, Plant and Equipment').

(c) Substantive analytical procedures – factors to be considered

Tutorial note: *The wording of the requirement clearly requires the application of any knowledge of ISA 520 'Analytical Procedures' to planning the extent of substantive procedures in the context of BZG's income.*

- Audit objectives – The principal audit objective relating to income is to ensure the completeness of recording. Analytical procedures can be effective in providing assurance in this area, especially where it is inefficient to perform tests of control or detailed substantive tests.
- Nature of entity – BZG's income will be seasonal, with more visitors in fine weather, at weekends, during school holidays and on national holidays. The relationship between income and weather/dates will provide a basis for making comparisons year-on-year.
- The greater the degree of disaggregation of information, the greater the extent and reliance on substantive analytical procedures. For example, sponsorship income will be clearly distinguished from ticket income. Also, income from sales of food and retail will be separately identifiable from admissions.
- Availability of information – non-financial information, as well as financial information, should be available on which to base predictions. For example, recorded admission fees can be compared with the number of visitors passing through a gate. This number may also be verified on departure (e.g. through turnstiles).
- Reliability of information – 'gate' will be more reliable if physical barriers are independently supervised to ensure that visitors cannot otherwise gain admittance.
- Relevance of information – budgets will be more reliable if based on realistic rather than ideal targets (e.g. achieving 70% rather than 100% sponsorship).
- Source of information available – for verification of completeness of recorded sponsorship income there will be nonfinancial records of the animals. External sources of information might include weather reports and local newspaper reports of major donations, sponsorships, etc.
- Comparability of information – as the nature of the BZG is quite specialised there may be no broad industry data available. Therefore most of the comparisons will be with prior period information.
- Expectation of relationships – as well as seasonal relationships, there will be an expectation that the higher the 'gate', the higher the income from food and retail.
- Materiality – as income is the item most material to the income statement, audit evidence regarding its completeness should not be confined solely to analytical procedures. For example, tests of detail on the sponsorship of the larger animals might be expected.
- Other audit procedures aimed at the same audit objective – BZG will have trade receivables in respect of sponsorships (invoiced) on which other procedures can be carried out. For example, review of credit period taken. However, there will not be amounts due for admission fees and retail sales (cash).
- Accuracy of predictions – food and retail sales are likely to have established margins – therefore the completeness of recorded income from these sources may be predicted

more accurately than sponsorships (say) where there are no directly attributable costs to be verified.

- Inherent and control risk assessments – as much of the income is cash, inherent risk is assessed as high. However, if controls over the issue of tickets are strong, more reliance may be placed on analytical procedures than if control risk in this area was assessed as high.
- Tests of controls – if BZG's controls over recording non-financial information (e.g. 'gate') are strong, then more reliance can be placed on analytical procedures using this information.

ANSWER TWO

HARRIER MOTORS

(a) Audit risks

Inherent – financial statements level

- Major business expansion increases going concern risk due to increased dependence on financing and the risk of overtrading. This must be taken account of when planning the audit so that, on completion of the fieldwork, sufficient audit work has been obtained to support management's assertion that the going concern basis is appropriate.
- Multi-locations increase inherent risk. For example, the movement of assets between locations creates a risk of double-counting and/or omission. Inter-location trading (e.g. of parts inventory) may be transferred at a mark-up which must not be recognised until realised.
- It is in the nature of the car trade business that sales are transacted for cash. If controls over the recording of cash income are inadequate this would cast doubts on the truth and fairness of the financial statements as a whole. For example, cash may be spent on capital and/or revenue items and not recorded as business assets/expenditure.

Inherent – assertion level

- The legal form of the consignment inventory is that Harrier Motors does not own it and should therefore not recognize it in the balance sheet. However, Harrier does not return new cars and therefore the substance of the transactions with the supplier is that they are purchases. That Harrier effectively has the rights of ownership and should recognise unsold cars in inventory is supported by the fact that the sales executive can use any car in each consignment. A physical inspection of new car inventory will therefore be required at the year end.
- For vehicles more than three months old, 3% purchase price is not a cost of acquiring inventory but a finance cost which should be expensed (time-apportioned if necessary to give accurate cutoff between accounting periods).
- Liabilities (actual and contingent) arising under the three-year warranties and six-month guarantees will require some provision (to the extent that they are expected to materialise) and disclosure, in accordance with IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.
    - Inventory valuation will depend on whether cars are new, used/trade-in, or ex-demo models. The year-end physical inventory count must ensure that each vehicle is appropriately categorised to ensure that it is correctly valued.
    - In particular, used cars accepted in part-exchange (on the sale of a new car), will be assigned a trade-in value which is the difference between the listed selling price on the new car and the cash consideration. Trade-in value may exceed the

net realisable value of used cars (which must be serviced in order that they are guaranteed before they can be offered for resale).

- As a member of key management personnel, the sales executive is a related party. Even though there is no consideration for the loan of the assets (new cars) IAS 24 'Related Party Disclosures' applies. There is a cost to Harrier which is the diminution in value between sales price of a new car and ex-demo price. In some jurisdictions this will be a benefit in kind assessable on the sales executive which should be disclosed as part of his remuneration package.
- WIP is unlikely to be material at the year end (as for the most part it is invoiced as finished work on the same day that it is undertaken). However, attention will need to be given to the cutoff between parts inventory (at cost) and completed WIP (at selling price).
- The term 'indefinite' does not mean 'infinite' but rather that the planned future expenditure on the brand name is in excess of that required to maintain the intangible assets at its current level of performance (IAS 38 'Intangible Assets'). This expenditure must therefore be verified to substantiate non-amortisation of the 'Uni-fit' brand name.
- As there is a rebuttable presumption that the useful life of an intangible asset does not exceed 20 years, Harrier's management must also subject the brand name to an annual impairment test.

Control risk

- The existence of an internal audit function may reduce the assessment of control risk on future audits. However, as the department is only now in the process of being established it is unlikely that much, if any, reliance can be placed on it in respect of the current year.
- To the extent that additional staff are recruited to the internal audit department before the year end, there is an opportunity for co-operation in verifying inventory and non-current tangible assets at the balance sheet date.
- Tests of control should be planned on continuous stock-checking to determine the extent of reliance to be placed on this internal control. In particular, Harrier's storekeepers should be carrying out test counts to a program which ensure that all inventories are counted at least once in each financial year. Discrepancies between book records and physical counts must be corrected by persons independent of the storekeeping function.

(b) Principal matters – instructions for physical inventory counting

- Harrier's year-end instructions should be approved by the newly-appointed head of internal audit. Any matters raised by the external auditor concerning last year's count (e.g. in a management letter) should be addressed.
- High value inventory (new cars) are held at three locations more than in the prior year and external audit staff might be expected to attend all three. Internal audit is not yet sufficiently developed to carry out tests of compliance on controls over inventory movements on a 'cyclical' basis. The newly appointed head (plus any additional staff recruited before the year end) should therefore plan to attend counts in consultation with the external auditors.
- Attendance at the counts is primarily a test for existence. As new cars contribute most to the valuation of inventory, they will most likely be 100% examined at all locations visited.
- Perpetual inventory records and continuous stock-checking provide a system of control over inventory quantities which, if effective, eliminates the necessity of a full physical count at the year end. If tests of controls in this area are strong Harrier will be performing test checks on a sample basis.
- The risk of material error arising due to cutoff will be reduced if new car consignments are not scheduled to be received close to the year end. The

likelihood of material error arising from work in progress is also low as servicing and body repairs are generally performed and invoiced on the same day.

- The greatest risks of material error arise if sales after the year end are brought into the current year sales – particular attention should be given to any cars which are seen to exist but are excluded from the count.
- Physical movement of new cars should be kept to a minimum (so perhaps no test driving on the day of the count).
- In selecting used cars for test checking it will be important to note their physical condition and any indications that they are slow-moving (e.g. if they are not easily accessible for a test drive).
- Consignment inventory which is more than three, six, nine, etc months old should be identified for later consideration of net realisable value. Mr Joop's car should be included in the count and any of his ex-demo models which are still in inventory.

(c) Audit work – useful life

Tutorial note: *'Indefinite' does not mean 'infinite'. Useful life reflects the level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating its useful life.*

- Agree the carrying amount (cost) to prior year working papers.
- Review the history of the 'Uni-fit' brand name. In particular, how many years it was in existence before it was purchased.
- Substantiate the level of marketing/advertising expenditure incurred on the brand name during the current year (by agreeing advertising to invoices, etc).
- Compare the accounting policy, of indefinite useful life, with that adopted for similar brand names in the industry.
- Review of planned future expenditure (i.e. advertising budgets) to maintain the brand name at the level of performance at which it was purchased.
- The results of management's impairment test (i.e. comparison of recoverable amount (per IAS 36) with carrying amount (i.e. cost).

ANSWER THREE

3 EAGLE ENERGY

(a) Capitalisation of staff training costs

(i) *Matters*

- Kshs.4·3 million represents less than 1·8% of total assets and therefore is not, in isolation, material to the balance sheet. It does, however, represent nearly 60% of profit before taxation and is therefore material.
- If Kshs.4·3 million were to be expensed profit before tax would fall to Kshs.2·9 million – which is only an eighth (i.e. 12·5%) of profit reported in the prior year.
- However true it may be that money is spent in the hope of future benefits, staff training costs do not usually meet the definition of an asset as there is insufficient control over them (IAS 38 'Intangible Assets'). They cannot therefore be intangible assets.
- Control might be claimed if Eagle had legal rights over the staff trained, to use and obtain future benefits expected from them. However, whilst this might apply to key individuals it would not apply to its entire technical staff.
- Whether any of the Kshs.4·3 million is a cost which can be deferred. For example, pre-payments for any part of the training program not run until after

the year end. Or training 'manuals' (bound volumes or software programs) which can be used over a future period of time.

- The chief executive's grounds, if any, for refusing to change the financial statements once it is explained to him that the audit opinion will be qualified 'except for' [disagreement] if he does not do so.

(ii) *Audit evidence*

- A break down of Kshs.4·3 million – analysed between external and internal training costs.
- Test checking the largest invoices for external training.
- Physical inspection of training manuals (or other training program related asset).
- The standard terms of the contracts with technical staff (confirming that Eagle Energy does not have sufficient control over them).
- Details of leavers – supporting the argument to the chief executive that future benefits are not protected as Eagle cannot prevent technical staff from taking up alternative employment elsewhere.

(b) Provision for 'decommissioning'

(i) *Matters*

- The provision made is 1/15th of the total expected cost and represents approximately 17% of profit before tax (PBT) which is material, but only 1/2% of total assets which is immaterial. Given that materiality based on PBT is exaggerated, because it is small compared to the prior year, on balance it is not material.
- However, the total amount to be provided, the present value of Kshs.18 million, will be material (the undiscounted amount is approximately 71/2% of total assets).
- Eagle Energy has a legal obligation to incur Kshs.18 million in dismantling/decontamination costs as a result of having assembled a laboratory during the year. The present value of this should be recognised, in full, as a liability (IAS 37 'Provisions, Contingent Liabilities and Contingent Assets') and as part of the cost of the laboratory (IAS 16 'Property, Plant and Equipment').
- The capitalisation of these future costs in the carrying amount of the asset would increase the depreciation charge for the year by 1/15th of the present value, which would be less than Kshs.1·2 million.

Tutorial note: *For example, assuming a discount rate of 6% the 15 year simple discount factor is 0·42. Therefore depreciation should be Kshs.0·5 million as compared with Kshs.1·2 million charged to the income statement.*

- The chief executive's grounds, if any, for refusing to change the financial statements once it is explained to him that the audit opinion will be qualified 'except for' [disagreement] if he does not do so.

(ii) *Audit evidence*

- Terms of local authority grant as documented in the permanent audit file.
- Physical inspection of the site at the balance sheet date – to confirm that the laboratory was assembled during the year and the obligation, for settlement in 2020, thereby created.
- Breakdown and calculation of the Kshs.18 million cost – whether estimated by Eagle's management or an independent consultant.

- Assumptions made in estimating the future cost (e.g. concerning degree of contamination).
- An appropriate discount rate – to calculate the adjustment that management should make (or quantify the impact of disagreement if the financial statements are not adjusted).

(c) Monthly adjustment

(i) *Matter*

- The net movement for the year, Kshs.0·3 million, represents only 4% of profit before tax and is therefore immaterial (and negligible to the balance sheet). However, although the net amount is immaterial, consideration should be given not only to the amounts of the adjustments made but their nature.
- The journal entries have no economic substance – they are a manipulation of financial reporting information.
- The fact that the journals are reversed does not mitigate the fact that the adjustments appear to have been made solely to misrepresent reported debt ratios. They are therefore false and, being intentional and deceitful (to obtain/maintain a financial advantage) constitute fraud.
- The adjustments have clear characteristics of being fraudulent journal entries:
  – made to unusual accounts – 'Sundry 1' and 'Sundry 2';
  – approved by an individual who typically would not be involved in making journal entries (the chief executive);
  – recorded at period end with no description.

(ii) *Audit evidence*

- List of all such journal entries made (and reversed) during the year.
- Terms and conditions of government funding (from permanent audit file for on going finance and new contracts entered into during the year).
- Recalculation of what the debt ratios should have been, without the adjustments, and whether these indicate a breach of conditions.
- Management representation, signed by the chief executive, that there are no other transactions of a similar nature which have not been brought to the attention of the auditor.
- How the matter was addressed by the prior year audit in respect of the prior year financial statements.

Overall

The chief executive clearly has a position of influence within Eagle Energy. Profit is materially overstated by the capitalisation of staff training costs. If he refuses to adjust the financial statements when requested to do so this would be a further instance of fraudulent reporting and the appropriateness of reporting this to relevant government authorities (as well as qualifying the audit opinion) should be considered.

ANSWER FOUR

ROOK & CO

(a) Quality control in a smaller audit firm

Why difficult to implement

Audit quality depends, *inter alia*, on the quality of the people. Smaller firms may lack resources and specialist (audit) expertise. In particular, small firms may not be able to offer the same reward structures to attract and retain staff as larger firms.

Also, whereas larger firms can afford to recruit staff in sufficient numbers to allow for subsequent leavers and provide for their training needs, smaller firms may not be able to offer the same training opportunities. Prospective trainees may perceive a smaller firm's client base to be less attractive than that of a larger firm (e.g. in terms of the on-the-job training which it offers).

Smaller practices may have less scope to provide staff with internal and on-the-job training and costs of external training may be costly in comparison and also fail to provide the 'hands-on' experience necessary for professional development.

The cost of access to external specialists may be prohibitive for smaller firms.

Audit committees play an oversight role which contributes to quality control in larger firms (e.g. on matters of client acceptance/retention, independence issues, etc). When the client base is largely of owner-managed businesses, as for many smaller audit firms, there are no non-executive directors to support the auditor when difficult issues arise.

Quality control requires leadership within the firm. In a larger firm one senior partner may have responsibility for establishing quality control policies and procedures and another, responsibility for monitoring work performed. Splitting these roles may not be practical for a smaller firm (and impossible for sole practitioners).
Small firms operate in a highly competitive environment for audit work and are often busy with non-audit work and under-resourced. Technical updating on audit matters may not be as regular as desirable and audit practice may become inefficient.

How overcome
Where in a larger firm quality control procedures might be the responsibility of a central technical team, in a smaller firm those same responsibilities might be distributed between the reporting partners.

Smaller firms may draw, judiciously, on the expertise of suitably qualified external consultants (e.g. on technical matters).

Small firms and sole practitioners have the same access to a wide range of technical and ethical advisory services provided by ACCA (and other professional bodies) and should take advantage of these.

Small firms may work together as a consortium to share training opportunities and sometimes staff. For example, an association of small firms may adopt the same methodology and meet annually (say) for technical updates.

(b) Lammergeier Group – auditor's report

- The report is confused. It is clearly headed 'Qualified opinion arising from disagreement …' yet the reasons for departure (from IAS 7) are 'sound and acceptable'. The heading is a statement of disagreement, the latter a statement of concurrence. If the auditor concurs with a departure the opinion should not be qualified.
- What is 'IAS 7'? This should be stated in full, i.e. 'International Accounting Standard 7 *Cash Flow Statements*'.
- It might be simpler/clearer to head the opinion paragraph 'Qualified opinion arising from omission of cash flow statement'.

- The auditors should not be expressing an opinion of Lammergeier's management in their report. Management's 'justification' should be set out in a note to the financial statements (e.g. in the accounting policies section). The auditor's report should clearly state that there is non-compliance with IAS 7. For example, 'As explained in note … the financial statements do not contain a cash flow statement as required by IAS 7 [written out in full]'.
- It cannot be true that the departure 'does not impact on the truth and fairness …'. The requirement to prepare a cash flow statement (and its associated notes) stems from the need to provide users of financial statements with information about changes in financial resources. If this information is omitted the financial statements cannot show a true and fair view.
- 'Except for [the non-preparation of the group cash flow statements and associated notes] ….' is a qualified audit opinion. This contradicts Rook & Co's assertion that the matter 'does not impact on the truth and fairness …'.
- If the departure from IAS 7 were justified it would assist the user of the financial statements to know precisely where the 'adequate disclosure has been made'. If the auditor wished to emphasise the matter, without qualifying the audit opinion, an emphasis of matter *after* the opinion paragraph should refer to the specific note where the departure is explained.
- The grounds for non-compliance is 'the complexity involved'. This does not seem likely. IAS 7 offers no exemption on these (or any other) grounds.
- The fact that the audit opinion was similarly qualified in the prior year shows that the matter has not been resolved even after a year.
- It is possible that, having qualified on the prior year, it was an 'easy option' to qualify again in the same terms rather than draft a more appropriate opinion for the consecutive year.
- The 2003 opinion makes no reference to the fact that the matter is 'not new' and that the opinion was similarly qualified in the prior year.

ANSWER FIVE

HAWK ASSOCIATES

(a) 'Cold calling'

Tutorial note: *Recognising that there are three issues to address (i.e. 'cold calling', 'free' and 'second opinions') is likely to earn more marks than focusing on just one.*

- Until relatively recently 'cold calling' has been largely prohibited throughout the profession (and still is in some countries e.g. Hong Kong). Therefore the 'direct' approach may not be suitable.
- Where 'cold-calling' restrictions have been relaxed it may still only be permitted for existing business clients (i.e. to offer them additional services), the direct approach to non-business clients being prohibited. This inhibits competition.
- Although the practice may be viewed as 'a bit grubby and commercial' it is now generally regarded as an accepted modern business practice. Along with other professional bodies, ACCA removed its prohibition on 'cold calling' in 2002.
    - Whilst Hawk is permitted to 'cold call', the fundamental ethical principles must be adhered to. Whilst solicitation which is decent, honest and truthful may be acceptable, cold calling which amounts to harassment is not.
    - Offering a service for 'free' is not prohibited provided that the client is not misled about future levels of fees.
    - There are strict ethical rules regarding 'second opinions' (on accounting treatments). Practitioners are advised NOT to provide second opinions, when requested, without following a procedure of contacting the incumbent

auditor/accountant. Therefore to be offering second opinions clearly goes against ethical guidelines – as the practice is to be discouraged.

(b) Tax planning

- Advertising is generally allowed subject to the observance of the fundamental principles of ethical codes (e.g. IFAC's 'Code of Ethics for Professional Accountants', ACCA's 'Rules of Professional Conduct').
- Although direct advertising (i.e. on television, radio, cinema) is prohibited in many jurisdictions (e.g. Hong Kong), an advertisement in a national accountancy magazine is generally permitted.
- Where advertising is permitted, the minimum requirements are that it be decent, honest, truthful and in good taste. These criteria may not be met in this proposal as:
    - expectations of favourable results (lower tax liabilities) may be unjustifiable (or created deceptively);
    - 'techniques you can apply' may imply an ability to influence taxation authorities;
    - 'the best' is likely to be a self-laudatory statement and not based on verifiable facts;
    - 'the best' may also be making an unjustifiable comparison with other professional accountants in public practice;
    - 'the best tax planning advice' may be an unjustifiable claim of expertise or specialism in the field of tax.
- 'Can ensure …' and the assertion of 'all' may not be supportable claims, therefore the advertisement is not honest in these respects.
- There is a 'fine line' between tax avoidance and tax evasion and 'techniques you can apply' and 'alternative fact presentations' may lean toward the latter and so not be in keeping with the integrity of the profession.
- The assertion of being able to 'minimise the amount of tax' may expose Hawk Associates to litigation. The engagement risk associated with taking on this work would be high and so should carry commensurately high fees.
- The 'no tax saving – no fee' offer does not compensate for the risk associated with undertaking the work advertised.
- Contingency fees, whereby no fee will be charged unless a specific result is obtained, are prohibited by IFAC (unless otherwise permitted by statute of member body).

(c) Business cards

- Business cards may be considered a form of stationery and should be of an acceptable professional standard and comply with legal and member body requirements concerning names of partners, principals, professional descriptions, designatory letters, etc.
- Whilst placing such an advertisement where a target audience might reasonably be expected to exist (e.g. in an Institute of Directors or Business Men's Club), displaying it alongside 'local tradesmen' may appear to belittle the status of professional accountants.
- An advertisement the size of a business card would be sufficient to provide a name and contact details and in this respect is suitable. However, the danger of giving a misleading impression is pronounced when there is such limited space for information.
- However, the tone of the advertisement may discredit the ACCA name. It is also unsuitable that it seeks to take unfair advantage of the ACCA name. Although the ACCA mark can be used by Hawk Associates on letterheads and stationery (for example) it cannot be used in any way which confuses it with the firm.

- The emphasis on 'professional' may be unsuitable as it could suggest that there are other than professional accounting, audit (etc) services to be had.
- Offering a range of non-audit services in the same sentence as 'audit' may mislead interested persons picking up the card into thinking that Hawk can provide them together. This conflicts with the fact that Hawk is restricted in providing non-audit services to audit clients.
- There is no basis for asserting 'competitive rates'.
- It is unlikely that any professional would offer 'money back'. In the event of dispute (e.g. over fees), the matter would be taken to arbitration (with their member body) if a satisfactory arrangement could not be reached with the client.
- A tradesman may guarantee the quality of his work – and that it can be made good in the event that the customer is not satisfied. However, an auditor cannot guarantee a particular outcome for the work undertaken (e.g. reported profit or tax payable). Most certainly an auditor cannot guarantee the truth and fairness of the financial statements in giving an audit opinion.

ANWER SIX

FRAUD AND ERROR

Tutorial note: *The answer which follows is indicative of the range of points which might be made. Other relevant material will be given suitable credit.*

(a) Auditor's responsibility

Fraud versus error

- Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement is intentional or unintentional.
- Fraud may involve forgery (or other sophisticated and carefully organized schemes designed to conceal), deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

Detection of fraud and error

- The auditor is responsible for assessing the risk of misstatement in a financial statement audit whether due to fraud or error. However, the auditor's responsibility for detecting fraud is different due to the characteristics of fraud.
- The risk of not detecting a material misstatement arising from fraud is higher than that from error because of the deceit involved in fraud. Attempts at concealment are even more difficult to detect when accompanied by collusion (which may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false).
- The auditor's ability to detect a fraud depends on many factors (e.g. the frequency/extent of manipulation, degree of collusion, relative size of amounts manipulated, seniority of individuals involved). While the auditor may be able to identify potential opportunities for fraud, it may be impossible for the auditor to determine intent, particularly in matters involving management judgment (e.g. accounting estimates).
- Audit procedures that are effective for detecting error may be ineffective for detecting fraud.

Reporting of fraud and error

- To shareholders – the auditor has the same responsibility under ISA 700 'The Auditor's Report on Financial Statements' for fraud as for error. For example, if the auditor is aware of a limitation of scope or disagrees with an accounting treatment the audit opinion will be qualified (assuming the matter to be material). However, if a matter is not material, it cannot be reported.

- To management and those charged with corporate governance – the auditor should report a matter which identifies or indicates fraud as soon as practicable to the appropriate level of management. This is even if the matter appears inconsequential (e.g. a minor defalcation by an employee). However, the auditor would not report such inconsequential errors.
- To regulatory and enforcement authorities – ordinarily, reporting to third parties on both fraud and error is precluded by the auditor's professional duty of confidentiality. However, the auditor may have a duty to report the occurrence of fraud in some countries.

(b) 'Professional skepticism'

- Professional skepticism recognizes the possibility that circumstances may exist that cause the financial statements to be materially misstated.
- It is an aspect of 'rigor' that information and explanations obtained are assessed and additional evidence sought as necessary.
- Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risk of material misstatement. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- The auditor must be prepared to consider that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity and the auditor's belief about the honesty and integrity of management and those charged with governance of the entity.
- When making inquiries and obtaining other audit evidence, the auditor exercises professional skepticism so as not to be satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity.
- An audit of financial statements rarely involves the authentication of documentation, nor is the auditor trained as (or expected to be) an expert in such authentication. However, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over its preparation and maintenance where relevant. Unless the audit reveals audit evidence to the contrary, the auditor ordinarily accepts records and documents as being genuine.

(c) 'Earnings management' – Difficulties for the auditor

- Earnings management aims to deceive users of financial statements by influencing their perceptions about the entity's performance and profitability. At its extremes, it constitutes fraudulent financial reporting. There are four broad categories:
  - intentional breach of financial reporting requirements which are, in isolation, immaterial;
  - unsuitable revenue recognition;
  - 'big bath' provisions/reserve accounting;
  - improper accruals/estimation of liabilities.
- Overly conservative reporting (e.g. creating reserves in good times for release on 'rainy days') and aggressively optimistic outcomes both hold consequences for the quality of financial reporting.
- Earnings management may be relatively innocuous (a 'tendency') and within gaap, or so aggressive as to constitute fraud (i.e. in violation of gaap). One difficulty for the auditor is establishing the boundary between acceptable and unacceptable earning's management and an intention to commit fraud. This is a matter for judgement and requires an attitude of professional skepticism.

- Earnings management may start out with small biased judgments in financial reporting and/or structuring transactions. If amounts are individually immaterial 'standard' audit procedures may not detect them.
- Making use of flexibility in accounting estimates is often the beginning of aggressive earnings management. Such flexibility may develop 'creative' choices. Accounting standards need to be rigorous and not so imprecise that it is impossible for an auditor to obtain sufficient, appropriate audit evidence to confirm the amounts derived under them.
- Pressures and incentives may lead these actions to increase to the extent that they are not acceptable under the applicable financial reporting framework. Controls that otherwise may appear to be operating effectively may be overridden by management. In such a case it is likely that management representations cannot be relied on.
- Opportunities for earnings management arise, in particular, where there is no accounting standard covering a particular accounting issue. As many techniques of earnings management involve accruals the auditor must be alert to the level of accruals appropriate to the industry and client and the appropriate recognition of liabilities.

ANSWER SEVEN

PRACTICE ORGANISATION CHOICE

Key Answer Tips

Part (a) requires a summary of advantages and disadvantages and is fairly straightforward

Parts (b) and (c) require you to demonstrate an awareness of the changes and developments in structure of partnerships in the form of Limited Liability Partnerships and companies.

(a) **Partnerships**

This is the most common structure for an accountancy practice (this would include sole traders). Historically it was the only option available for a professional setting up in business.

Advantages

- It is a familiar structure and hence will appear 'trustworthy'
- Partners are taxed under the schedule D rules and hence there can be advantages with the timing of the payment of tax
- The amount of national insurance paid by a self employed individual is lower and hence this can be advantageous
- There is a reasonable amount of flexibility in structure

Disadvantages

- There is joint and several liability – hence you could be liable personally for the negligent act of one of your partners
- There is unlimited liability – hence your personal assets are in danger in the case of major litigation and/or liquidity problems for the practice
- The lower payments of national insurance can impact on future state benefits for the partners
- In many cases the lack of a formal partnership agreement can cause problems in the case of a dispute and/or split of the practice.

(b) **Limited Liability Partnerships**

The legislation enabling partnerships to incorporate as limited liability practice was put in place in 2000, allowing for the first practices to incorporate in the early part of 2001. This is a familiar structure in the USA and many experts believe that over it will become to most common structure for professional practices in the UK.

Advantages

- The most obvious one is limited liability – however a negligent partner will still be personally liable for his own negligent acts, hence it is the issue of joint and several liability that is dealt with
- The taxation rules are the same as those for a partnership
- A practice changing to a limited liability partnership will be treated as continuing for taxation purposes
- There may be some other tax advantage s- for example capital gains tax
- It may be easier to attract new partners due to the limited liability status

Disadvantages

- The structure is new and hence many people may find it difficult to 'trust'
- Although liability is limited there is still potential exposure for individual partners
- As a limited liability organization the business will have to file accounts and hence certain information that was generally private will be made publicly available
- There is a possibility that the firm will need to have an audit undertaken.

(c) **Incorporated Audit Firms**

Up until Companies Act 1989 firms were not allowed to incorporate, however, at the same time as audit regulation being introduced firms were for the first time given an opportunity to incorporate. Many believed that this would be an opinion taken up widely within the profession but so far this has not happened.

Advantages

- The most obvious again is the existence of limited liability
- Many feel that this gives the firm more flexibility, particularly in mixed practices
- There can be tax advantages in that there is the opportunity to pay dividends as well as salaries
- It may be easier to attract new 'partners' due to the limited liability status hence the newcomers do not feel that they could be held personally accountable for the actions of the old partners.

Disadvantages

- The company will have to file its accounts, although small or medium accounts can be filed if the qualifying criteria are net
- If the turnover is above the audit exemption level then an audit would be required
    - Many people are still suspicious of a practice that has decided to incorporate suspecting their motives for making the change
    - Although there may be tax advantages associated with dividend payments, the directors are also likely to have a salary under the PAYE system and hence the timing of the payment of their tax is not as beneficial.

ANSWER EIGHT

EXPECTATION GAP

Key Answer Tips
Note here the requirements are highly specific and expect you to focus on the practicality of the three proposals given. The question is based to an extent on the widely discussed topic of 'to whom does the auditor owe a responsibility?'

A sensible structure for your answer might be to take each element of the statement contained in the question and comment on it. Note that you are expected to suggest your own proposals where you feel the suggestions in the question are not practical.

A sound answer would, of course start with a summary of the main implications of the Caparo decision.

(a) The *Caparo* decision limits the parties who may successfully sue the auditor for negligence to the company and shareholders as a body. No other party is entitled to damages if there are material errors in the accounts. Essentially, it appears that the decision is based on the fact that only persons who have a contractual relationship with the auditor can make a successful claim (i.e. those who have paid a fee to the auditor). In some respect this decision is reasonable, as it seems unfair that a third party should be able to successfully sue an auditor for damages when he has paid nothing towards the cost of an audit. However, the *Caparo* decision does appear to have reduced the credibility of the audit report and hence audited accounts.

In almost all circumstances, a set of accounts should have the same meaning to the company, existing shareholders and third parties, so I believe it is unreasonable for auditors to argue that an error or the company's management. Also, if third parties believe audited accounts may not be accurate, this can affect decisions by potential investors and banks who lend money to companies. The long term effect is likely to be that investors will be less willing to purchase shares of companies which will result in a fall in share prices and companies having increasing difficulty in raising new funds. Also, banks and individuals will be less willing to lend money to companies.

Thus, I come to the conclusion that it is probably unreasonable that auditors should be liable for negligence to a wider range of third parties. However, it is desirable that accounts of companies should be accurate to ensure that third parties will be encouraged to buy shares and lend money to businesses. Unless auditors are liable to third parties negligence, it appears that the credibility of audited accounts will continue to be eroded. There appear to be a number of solutions to this problem, including:

(i) Companies could pay an additional fee to the auditor, so that the auditor's liability includes potential shareholders and creditors. However, it may be difficult for the third party to make a successful claim against the auditor, as no consideration has passed between the third party and the auditor.
(ii) The third party could pay a fee to the auditor to confirm the accounts are correct
(iii) There could be a change in the law so that certain third parties are included.

Ideally, option (i) appears to be the optimum solution provided auditors are prepared to accept this additional potential liability. Option (ii) could be

expensive for the third party if the investment or loan is small. However, it does have the advantage that the auditor would be aware of the parties to whom he will be responsible if a case of negligence arises. Option (iii) is likely to be inflexible and may include third parties the company and its shareholders do not wish to protect. For instance, in a family controlled business where there is no intention to sell the business, it would be a waste of money for the company to protect investors.

(b) The statement in the question that the auditor has no duty to detect and report on the fraud is incorrect. ISA 240 on the auditor's responsibility in relation to fraud and error says that the auditor should 'design audit procedures so as to have a reasonable expectation of detecting misstatements arising from fraud or error which are material to the financial statements.' So, the auditor is not responsible for dejecting immaterial errors or fraud. It appears that he is responsible for detecting material errors and fraud. However, if a set of accounts is subsequently shown to have material errors or fraud, the auditor may use as defense against the allegation that the fraud or error was deliberately by the company's management, and it would be unreasonable to expect the auditor to detect it using normal audit procedures.

I believe that auditor's current responsibilities in relation to error and fraud are reasonable for both the auditor and the general public. It would be unreasonable to ask the auditor to detect all errors and fraud (including immaterial ones), as it would increase the cost of audit substantially and the final result will probably not be cost effective (i.e. the increased audit cost of detecting errors and fraud will be greater than the value of errors and fraud detected). Also, uncertainties in relation to error fraud are difficult to deal with. For instance, can an auditor be certain that all expense claims by employees are correct? There may be insufficient evidence to confirm or refute these claims.

However, if the auditor is only responsible for detecting material error and fraud, this enables him to ignored immaterial items and it does not require him to report on small errors and frauds. So, the auditor performs a more cost effective audit. For investor would argue that they are only interested in material error and fraud, so the current situation satisfies them as well.

In the UK, most institutions who hold clients' money and invest money for them are covered by the financial Services Act 1986. This places additional responsibilities of the auditor, and it allows the auditor to report to the regulator f the responsible body if there are any breaches in regulations – the Financial Services Act allows the auditor to report in this way, without being liable to the client for the breach of confidence. Also, the auditor has to make an annual report to the regulator of a firm's investment business.

A further requirement of the Financial Services Act is that the auditor has to report on these controls. Solicitors and estate agents are covered by rules of their professional body over client's money and the client accounts have to be audited by a registered auditor.

So, for investment businesses there is a more erroneous audit requirement than for companies.

Most company pension funds are not covered by the Financial Services Act, but if the pension fund receives investment advice (which is probable) the body giving this advice is required to comply with the Financial Services Act.

I believe this requirement is unreasonable, as many investors involve risk, with a chance that the value of investment will decrease as well as increase (e.g. in 1991 the index of the share price of the largest 100 firms in the UK (i.e. FTSE) fell by 13%). If there was a requirement for no loss, all investment businesses would have to make very safe investments (e.g. in government fixed interest securities), and this would not satisfy the requirements of any investors.

So, it is unreasonable ask the auditor to ensure that no loss occurs on investments held by a financial institution. However, there does appear to be a need for the auditor to ensure that funds are invested in accordance with the wishes of the investors that unauthorized investments are not made and there is no fraudulent misappropriation of these funds, or investment in funds with a view to committing a fraud.

Fraudulent misappropriation of funds may be relatively easy to detect, but detecting investment in funds with a view to committing a fraud is more difficult to detect. For instance, the business may invest in a company (X Ltd) which is owned by one of the directors of the investment company and X Ltd is used to finance an expensive lifestyle for the director. It may be difficult to detect who runs X Ltd and whether it is likely to be a profitable investment.

A possible solution to this problem is to ensure that the investment trust only invests in certain types of business (e.g. companies quoted on the stock exchange) and that surplus funds are invested securely (e.g. in either a UK clearing bank deposit account or government securities).

With some recent major frauds, such as Barlow Clowes, and the alleged misappropriation of funds from the Mirror Group Newspapers pension fund, it may appear that the only solution is that the auditor should be present at al times to check on all investment transactions. However, it would be expensive for the auditor to be permanently present to check transactions, and many people would argue that it would interfere with the running of the business.

The main problems with these businesses was a weakness in the system of internal control due to a dominant chief executive. With Barlow Clowes, it appears that although the investors believed the company was investing in government fixed interest securities, there was a clause to make 'other investments' which were then used to fund the extravagant lifestyle of the proprietor of the business. The solution to this problem is to prohibit 'get out clauses'. Then the auditor will be able to report to the regulator if the company is cot complying with its investment rules. Most of Barlow Clowes fraud took place before the Financial Services Act came into force, so it could be argued that it would have been detected earlier if the act had been in force during all of Barlow Clowes existence.

With Mirror Group Newspapers pension fund, Robert Maxwell was the chairman of trustees of the pension fund, and he owned the company which dealt with the pension fund's investments. There is a problem of who should be the chairman of the trustees of a pension fund, and whether employees or the company should have a majority of the trustees. As a pension fund is for the benefit of the employees, and is legally separate from the company, I believe the employees should be the majority of the trustees and one of their number should be chairman of trustees.

However, it could reargued that the company makes significant contributions to the pension fund (usually morethan the employees) and the company is usually required to

fund any deficiency in the pension fund assets. These reasons could justify the company having the majority of trustees.

My view is that the pension fund should be seen to be independent of the company and that the majority of the trustees should be employees (rather than representatives of the company). An alternative would bet have the employees and the company's representative.

On investment by pension fund, there are limits over the amounts of the pension fund assets which can be invested in the company. These limits could be further tightened. The major problem with the Mirror Group Newspaper pension fund appears to be that the investment adviser was owned by Robert Maxwell and that it invested in private companies owned by Maxwell. Also, I provided loans and guaranteed loans to companies controlled by Maxwell.

I believe that there should be legislation to limit investment by pension funds in companies owned by the directors of the company. An alternative is to authorize certain companies to advise on investment by pension funds (similar to authorization under the Financial Services Act) and to disqualify an investment advisor which has any connection with the company or its pension fund. By 'connected' I mean that none of the major shareholders or directors of the investment adviser should be directors of the company or trustees of the pension fund.

So, I believe the employees should be majority of the trustees of a pension fund, and pension fund advisors should be independent of the company and the pension fund. This new requirement for independence of pension fund advisors will probably require a statutory backing.

The solution to many of the problems with investment companies and pension funds is that there should be a proper system of internal control in these organizations. With both Barlow Clowes and the Maxwell pension funds there was a dominant individual who prevented the operation of effective internal controls. I believe the auditor should report if the controls are effective and report to a supervisor by body if they are ineffective. Legislation may need to be introduced to take action against investment companies and pension funds here controls are not effective (e.g. by an independent body taking over the control of these organizations). I do not believe that requiring the auditor to be present at all times is an effective way of overcoming these problems.

ANSWER NINE

BECHER CONSTRUCTION

KEY ANSWER TIPS

This is a wide ranging question designed to test your knowledge of basic aspects of corporate governance.

Easy marks are available here, but always, you must address the question as set so plan your answer first. Note that part (a)asks what and why – you must deal with both. In part (b) jot down a list of key issues as a wring before you start answering the question. Part (c) requires you to understand the concept of an audit committee and to deal specifically with its role in 'demonstrating corporate governance- what do you think 'demonstrating' here means? Effective reporting is seen as a key feature of good corporate governance – draw on your financial and management accounting knowledge.

***Tutorial note**: The question is aimed at testing the knowledge and understanding of the candidate on corporate governance and the roleof internal review. It requires a report therefore a report format should be used sating out clearly the key messages in a logical structure to meet the requirements set out and the*

audience being addressed. This will be an area that the candidate will be expected to keep up-to-date on the latest developments and best practice.

Report

To: Audit Committee Becher Construction

From: Internal Auditor

Date: xxxxxxxx

Subject: Meeting Corporate Governance 'Best Practice'

(a) **Corporate Governance**

Corporate Governance concerns the ways that a company is operated and directed. It encompasses the following key aspects:

- Operation of the Board and Audit Committee
- Overall control and risk management framework

Corporate Governance has become increasingly important to all organizations, particularly those with a stock exchange listing which are subject to the requirements of the Combined Code, Cadbury and Turnbull reports.

The Turnbull requirement requires that companies have an ongoing process for identifying, evaluating and managing the company's key risks that it is regularly reviewed by the board and accords with guidance. Breach of these requirements could result in not only qualification in the annual accounts but damage to the company's reputation.

(b) **Requirements of Corporate Governance**

Becher need to ensure that the following key requirements are met:

- Evaluate risks within the organization. The key risks across the organization need to be identified, measured and reported. In many organizations, this has involved identifying the top 20 or so risks, which are then fully co-ordinated by the Board and Audit committee.
- Consider the nature and extent f the risks regarded as acceptable. There needs to be a clear understanding of the 'risk appetite' of Becher as well as the nature and extent of the top risks.
- The threat of such risks realizing, assessing both the impact and likelihood.
- The ability to reduce incidence and impact if risks arise. This will include a review of the appropriate contingency arrangements are in place.
- Costs and benefits relating to operating relevant controls will need to be considered.
- Corporate Governance concerns the culture of the organization not just from its risk appetite but also the risk awareness and understanding across the organization. The Board and Audit Committee need to asset the tone and appropriate supporting mechanisms need to be in place, including appropriate training, policy and procedures.
- Regular reporting to demonstrate that risks are being managed on an ongoing basis.

(c) **Role of internal Audit**

Turnbull says that an objective and adequately resourced internal audit function should be in a position to provide the Board with much of the assurance it requires regarding the effectiveness of the system of internal control.

Internal Audit's main role is normally to evaluate risk and monitor the effectiveness of the system of internal control. Turnbull sets out the requirements for an organization and these have a key bearing on how internal audit should operate.

The role of internal audit will depend on the nature and type of organization and what other risk type functions are in existence within the company.

Key steps for internal audit will be to:

- Review the companies measures to achieved corporate governance
- Ensure that Internal Audit's operation is consistent with the major risks facing the organization]produce analysis and opinions of the effectiveness of the organization's control mechanisms, including regular information to the Board and Audit Committee.

(d) **Role of the Audit Committee**

The role and importance of the Audit Committee has increase as the corporate governance requirements have increased. The audit committee must have at least three non-executive directors.

The audit committee should:

- Assess the framework for corporate governance within the company, including the risk policies and measures being taken to achieve requirements
- Review the top 20 risks established, including the impact and likelihood
- Require regular reporting from internal and external audit and any other review bodies, showing how the risks are being managed
- Received and review internal audit assignment reports and follow up information
- Discuss and consider any concerns of directors and internal audit
- Review annual financial statements and the result of the external auditors' examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Receive and deal with external auditors' criticism of management and ensure that recommendations of internal and external auditors have been implemented.

(e) **Types of regular reporting**

Types of regular reporting that could be produced for the audit committee include:

- Listing of current top risks and up-to-date assessment of impact and likelihood
- Reports on control risks including how they are being managed
- Details of nay issues/concerns that have arisen
- Audit reports issued and impact on corporate governance
- Information on follow up on outstanding risks and findings from reports

ANSWER TEN

MT INVESTMENTS

Key answers tips

This question focuses on practical ethical issues involved mainly in the context of outsourcing. Do not be put off by the question being set in the context of an investment company – it is quite likely that this had no major impact on the approach you will take to the answer.

Note that a favourite word of auditing examiners appears more than once in the question – the word 'issue,' usually meaning factors to consider in a given situation before making a decision.

Report

(a) To: MT Investment

From: External Auditor

Date: xx/xx/xx

Subject:: Key factors to consider on outsourced services

(i) Cost/benefit analysis (as a basis for planning)
A business case will be required to support whatever decision is taken. This needs to include the costs of provision of the internal audit service set against the quality of service provided and an evaluation of the relative merits and benefits of the provision.

(ii) Risk coverage
The level of service to be provided needs to be clearly set out, through an evaluation of the audit universe and risks to the company. Effective high level planning is critical to the success of any internal audit service and should include:

- Identification of key risks
- Frequency of audit review
- Justification of any plan
- Discussion with senior management on their understanding of risks.

(iii) Understanding of the organisation
Any audit team can bring knowledge of the process for assessing risks and controls but specialists may be required for certain aspects of the business, in particular for the technical funds management and treasury areas. These can be scarce skills that an outsourced firm may more easily be able to provide than a small in-house team.

(iv) Approach to auditing and best practice
The approach to auditing will be key to ensuring that auditors are directed towards the greatest areas of risk and that audits are undertaken efficiently and effectively. Methodologies may have been assessed against best practice through

an appropriate benchmarking tool – information available on such benchmarking should be available to support any decision made.

(v) Management information and reporting
Performance statistics will need to be established for the internal audit service, with regular reporting of performance against plan as well as identification of the extent that the organisation's objectives are being met and the coverage of the company's high level risks.

(vi) Corporate Governance
The internal audit function has a key role to play in corporate governance, in particular in assessing the level of risk exposure and how controls are being managed. Information on corporate governance can be obtained in a number of ways, ranging from the regular communication with management, internal audit reports, ad-hoc reviews and potentially corporate governance and risk workshops or surveys.

(b) Issues faced
The ethical issues have been particularly in prominence recently, with a body of opinion saying that external auditors should not undertake internal audit services because of the potential for conflict of interest and the obvious threat to independence. External auditors may be in a position of reviewing the service provided by internal audit which is in effect a review of itself. This may inhibit both the role of internal and external audit.

Ways around this include:

- Companies clearly separating out the internal audit services away from the external audit activity with 'chinese walls' operating between the two.
- An effective Audit committee can provide a strong counter-balance to any ethical concerns, since they will be in a position to review both internal and external audit services.

(c) Advantages and disadvantages of outsourcing
Advantages

- Greater focus on cost and efficient of the internal audit function
- Broader range of expertise
- Less vulnerable to high turnover or loss of staff
- Particularly useful for specialist, costly skills such as those required by MT
- Short term needs be met without incurring all year around costs.

Disadvantages

- Conflict of interest potential
- Pressure on independence arising from the cost associated with the provision of internal audit. The outsourced department may experience pressure from management either through a threat not to renew the outsourcing contract or to pay all fees.
- Lack of close working knowledge of organisational business and culture.
- Conflicting objectives and culture of the outsourced services and the company receiving the service.
- Potential of increased cost or less time on internal audit.

ANSWER ELEVEN

ISTHMUS PLC

Key Answer Tips

Note that this answer is expressed in the terms used in IFAC's 'Code of Ethics for Professional Accountants'.

(1) **Profit warning**

Ethical and professional issues

- The profit warning increases the inherent risk of this assignment. As more work may be needed than for the prior year (e.g. on Vanaka's impaired assets), additional staff may need to be assigned to the audit.

- An 'advocacy threat' may occur if a dispute arises between Isthmus and Kloser. For example, if the due diligence work should have recognized the significant impairments.

- Kloser should undertake a review of the due diligence work and audit for the year ended 31 December 2001 to ensure there were no findings which should have alerted them to the problems in Vanaka which precipitated the profit warning.

- A 'self review' may arise in that prior yearned audit which followed the purchase, may have lacked objectivity. For example, the involvement of the corporate finance department in due diligence may have resulted in less audit work being carried out on Vanaka's assets and operating results than would otherwise have been performed.

- If Kloser was negligent in undertaking the due diligence work (e.g. because assets were impaired at the time of acquisition and/or the assumptions underlying the expected synergies wee unrealistic/hypothetical), to whom will Kloser be liable? To whom was he due diligence work reported? (Isthmus, Isthmus's shareholders, providers of finance for the acquisition?)

Implications for staffing

As a safeguard for the provision of the other service (due diligence) the audit personnel seconded to the corporate finance department may not have participated in the audit for the year ended 31 December 2001. Any such 'bar' should continue.

If the secondees are involved in the audit, appropriate safeguards would include not assigning them to the audit areas most closely associated with due diligence and close monitoring and review of their work.

More senior/better quality experienced staff should be assigned to the audit (than would have been necessary had the profit warning not been issued).

(2) **Shares inherited**

Ethical and professional issues

- A 'self interest threat' has arisen as Mercedes has a direct financial interest in Isthmus (i.e. she controls the shares). In particular, in wishing the share price to increase Mercedes might be in a position to overlook unrecorded liabilities and losses discovered during the conduct of the audit (say).

- Even though Mercedes may have independent of mind and be known to act with the utmost integrity, she cannot have independence in appearance.

- This inadvertent violation (i.e. through inheritance) of an independence principle does not impair the independence of Kloser or the audit team providing:
  - Kloser's established policies and procedures have resulted in Mercedes having reported promptly her inheritance of the shares.
  - Kloser promptly advises Mercedes that the shares should be disposed of; and
  - The disposal occurs at the earliest practical date, or she is removed.

- Mercedes does not intend to dispose off the shares quickly as she is waiting for the share price to recover.

- It is unlikely that Kloser would consider offering her adequate compensation for an earlier disposal (the loss in share value since the fall being 5,000 x (Kshs.7.95 – 1.95) = Kshs.30,000).

- Although IFAC's independences statement requires Mercedes' removal from the audit team, Kloser may require stricter safeguards and prohibit all professional staff from holding direct financial interests. Mercedes may therefore be asked to choose between staying with the firm or disposing of the shares at the earliest practical date.

- If any work has been done by Mercedes on the audit of Isthmus since she inherited the shares (e.g. in reviewing interim audit work or planning the year end or final aduit visits) that work should be re-reviewed buy another professional accountant.

Implications for staffing

This threat is so significant that Mercedes should be removed from the audit team unless she disposes of the shares before she undertakes any further tasks relating to the audit of Isthmus.

(3) **Dealing in shares**

Ethical and professionals issues

- A self interest threat would have arisen only if Anthony had known that a close family member (a parent) had shares in Isthmus (but he did not). A self interest threat cannot now arise as his father has disposed off the shares.

- Providing Anthony did not knowingly prompt his father to sell the shares, he has not committed a criminal act (e.g. of insider dealing).

Tutorial note: If he committed such an act he should be instantly dismissed by the firm and any professional body under which he is registered (e.g. ACCA)notified for disciplinary action.

- However, if he in some way communicated (e.g. in a careless remark) something that prompted his father to sell the shares, he may be in breach of his duty of confidentiality. This should be investigated and appropriate action taken (e.g. he may be cautioned or given a written warning).

- If he unknowingly gave his father price sensitive information, then his father may be guilty of insider dealing (or similar) for having acted on it.

Implications for staffing

- Unless there is any reason to suppose that Anthony has acted improperly (e.g. if he has delayed disclosing the matter) here is no reason why he should not continue his position in the audit team.

- However, if his father were to come under suspicion of insider dealing then Anthony should be withdrawn from his assignment.

Overall

Given the high profile attaching to this listed client it would be timely to have all members assigned to the audit team renew their written declarations of independence and confidentiality.

ANSWER TWELVE

GAIS

Key answer tips

This question relates to the practical application of best practice and technology to effective practice management. You should carefully read the question and ensure that you provide appropriate recommendations and explanations, with supporting examples.

Part (a) requires you to explain the benefits of technology and to make specific recommendations on use within GAIS audit services. Automation is a continuing trend and you should reflect the changing and developing nature of IT.

Part (b) concerns quality control strategy and procedures and needs both an explanation and relevant proposals.

Part (c) requires you to comment on the risks posed by GAIS weaknesses in maintenance of working papers and explain how these risks could be avoided by introducing appropriate mechanisms.

(a) Benefits of technology

Overall, there are a number of significant benefits to the automation of GAIS audit services, in particular;

- It will increase professionalism of GAIS and enhance the image of GAIS audit services both internally and externally with clients. It will demonstrate the use of best practice techniques and compliance with appropriate standards for auditing.
- It will improve efficiency and should result in cost savings, in particular through standards documentation, rapid sharing of information and automatic generation of plans, programmes, schedules and working papers.

- It will enable more effective, risk focused audit work by targeting scarce resources and by allowing auditors to focus on thinking about risks, controls and accounts rather than how best to do.

Recommended uses of technology by GAIS

- Computerized audit working papers using either a word processing package to generate and store working papers and reports, through audit programme generators or though a standard audit package that automatically generates consistent standard for working papers and reporting.
- Spreadsheet packages for generating working papers and for calculations, testing and analytical review. Normally a PC will include a standard word processing and spreadsheet package. This should be consistent with GAIS standard to enable ready transfer between departments.

  - resulting in increased efficiency, effectiveness, risk focus and professionalism.
  - Will lead to more consistent and complete working papers

- Risk analysis software used to identify, calculate and evaluate risks within a company or department.
  - Increased risk focus, targeted audits, professionalism and improved PR.

- Communication including electronic email between clients via the internet and excellent internal communication where auditors are working across site even in different countries.
  - Increased efficiency and use of time, speedier response times.

- Knowledge management and sharing of information. Access to the internet will strengthen planning and background research, with the availability of regulations and rules governing auditing and accounting, increasingly holding audit reports and other relevant material.
  - More effective auditing, professionalism

- Planning and resource management software, including time recording systems, scheduling and skill records.
  - Will allow more targeted planning, with appropriate skills allocated and at the right time.

- Flow charting or diagrammatic software or generating documentation of systems.
  - There are a number of relatively low cost flow charting software that can be purchased and used by GAIS, that will provide mote consistent and effective documentation, that can be readily edited and updated. Again a GAIS standard would be sensible.

Computer assisted audit techniques will also allow GAIS to leverage IT to better effect with more effective sampling and testing. In particular trial balance precessors and interrogation software that: stratifies and analyses files, produces exception reports, compares information across the computer files, detects gaps or supplicate entries, re-performs calculations.

(b) **Quality control**

Quality control is not just a benefit to GAIS but is an essential requirement. SAS 240 requires that all firms implement quality control policies and procedures both at a firm and individual audit level. They should be communicated to all staff and monitored to ensure they are complied with.

The quality control procedures should provide the following additional benefits

- Ensuring the professional requirements are met
- Identifying any improvements including training and development of staff
- Supporting accepting and retaining clients
- Overall however the benefits are more that they provide protection against the risks of loss of client, financial loss and compensation and reputation damage.

The quality control procedure for GAIS should

- Ensure compliance with ethical guidance and SASs; and
- Be documented in the audit manual, along with the documentation of their methodology and ongoing mechanisms for review and compliance should be put in place.

(i) **Quality control procedures for GAIS audit services**
Professional requirements

All staff should comply with relevant professional codes of conduct and the GAIS code of conduct, ensuring honesty, objectivity, confidentiality and integrity.

This should be identified as important to GAIS at the recruitment stage and reaffirmed through guidance for example accepting gifts, dealing with clients.

Skills and competence
Ensuring the appropriate skills and competence of staff is important. All staff should be professionally qualified or be studying for an appropriate qualification. Skills will be assessed through the recruitment process and be monitored as part of performance appraisal processes. Training and development of staff will be carried out to ensure that appropriate skills and competence levels are achieved and that staff keep up-to-date with best practice.

Acceptance and retention of clients
Standard acceptance procedures are in place and any problems that may arise may impact retention of clients should be identified, documented and evaluated.

Assignment
Assignments should be performed accordance with standardized documentation. Assignment control and review procedures will ensure that individual audits are completed to a high standard, suing the right skills and resulting in a report that reflects the underlying facts (see ii).

Delegation
There should be sufficient direction, supervision and review of work at all levels so that work performed meets appropriate standards f quality. Supervisors will receive appropriate training in the conduct of this supervision and be appraised against the relevant management competencies.

Consultation
Internal and external consultation will be carried out to ensure that GAIS achieve and maintain leading edge delivery.

Monitoring
One these procedures are implemented, an annual review of their adequacy and effectiveness should be undertaken, with updates to the procedures as required. Other methods of monitoring will include peer reviews of work carried out.

(ii) Quality control procedures for individual audits

Direction and supervision of staff
An organization chart with job description set out the structure, organization and responsibilities of staff. These will be maintained and updated as appropriate.

The audit plan and resource/time allocation schedule will be used effectively to ensure that all team members are clear f the assignments to be undertaken and when. Time will be built for supervision of the work and all staff should feel they can consult supervisors if they encounter difficult situations in which they need advice.

Records of assignments performed and skills gained will be kept to ensure that an accurate 'skills database' can be held and that assignment evaluations can be carried out.

Review of work performed
All audit work should be documented in a timely and consistent way, in accordance with GAIS audit standards. Proper review procedures should be in place. All working papers must be independently reviewed to ensure that work has been performed in accordance with the audit plan, that the appropriate risks have been identified and that the evidence supports the conclusions. Before the audit report is finalized, the manger or partner should review the audit file and final accounts.

An annual peer review will be conducted to ensure that the audit standards, including quality control processes, are achieved.

(c) **Risks of inadequate working papers**

If working papers are inadequate:

- A clear report may be given instead of a qualified client
- Reports may be qualified unnecessarily
- Potential problems or risks for investigation my not be documented
- Audits may not be targeted effectively or carried out in accordance with plans
- GAIS may not be able to support conclusions made and could be subject to action through legal action, loss of client damage and reputation and adverse publicity.
- Audit work many need to be re-performed if not documented adequately and for subsequent year reviews important background information may not be available resulting in inefficiencies, additional costs and damages to client – GAIS relationship.

These risks could be minimized by complying with SAS 230. GAIS working papers should be maintained in accordance with audit standards and meet the following criteria:

- Document matters important to supporting the report and record reasoning to support judgment and conclusions made
- Sufficiently complete and detailed to provide an overall understanding of the audit
- Keep up-to-date during an audit
    - Sufficiently detailed and complete to enable nay auditor to pick up the work and understand the work carried out and conclusions reached

- Maintained in a confidential manner
- Reviewed in accordance with quality control procedures.

ANSWER THIRTEEN

PHONES ANYWHERE

Key answer tips

It is useful to note that a good example of an important style of examination question – it requires a sound knowledge of principles and the ability to apply them in a specific context. Treat this as a case study type of question – general answers will not score high marks, even if technically sound.
The examiner is testing your knowledge and the ability to apply it.

A good technique would be to take each piece of information given about the company and assess how you can apply it in dealing with the examiner's requirements.

Note that the mark allocation and reflect this in the time you devote to each part f the question. Note also that part (c) requires a conclusion – make sure you provide a conclusion which is well supported by arguments and facts.

(a) There appear to be considerable risks associated with undertaking the audit. In particular, Phones Anywhere appears to have a very high inherent risk. Looking at the matters in (a) to (k) in the question.

(i) The low coverage of the country will be a disincentive to new subscribers. Initially, subscribers will only be those who operate in the town with a population of 1,000,000. The service will not be available when he subscribers are outside that town. I will have to consider whether the company has the financial resources to develop to towns with a population of 250,000 in the net year and its planned developments to the year 20x0. The company's plans for extending the network do not appear to be realistic, as many mobile phones are used on motorways and trunk roads. Motorways will not be covered until the year 20x0 and coverage of other roads is not mentioned. These plans are likely to be a serious disincentive to new subscribers joining the system, when competitors cover most of the country.

(ii) The central computer is pivotal to the organization, as it relays the calls and calculates the bills for subscribers. Will this computer and its software be reliable? The consequences of a break down of the computer will be very serious. Ideally, there should be more than one computer running the system, and the system should be able to continue if one of the computers fails.

(iii) What is the capacity of the main computer? With the planned expansion, it is probable that it will run out of capacity in the near future. Is it possible to expand the capacity of the computer? Has the cost of upgrading the computer been included in future forecasts? Will the current software be able to process a large increase in subscribers, or will it have to be re-written (at a substantial cost)?

(iv) Is it reasonable to amortise the cost of the relay stations and main computer over six years? Six years may be realistic for the 'buildings' part of capital

expenditure, but it may be too long for electronic components including the main computer and transmitters.

(v) Is the discount paid to retailers for the purchase of phones recoverable? The question says it is capitalized and amortized over four years. Do subscribers remain connected to a single operator for as long as four years (if many changes in less than four years, this amortization period is too long), and are subscribers likely to change their phones within four years (to update to a more advanced model)?

(vi) Paying the executive directors a bonus based on the number of subscribers of the system could encourage them to obtain as many subscribers as possible (by offering discounted prices) rather than charging a realistic price which will ensure the long term future of the company. However, the executive directors should be concerned with the long term future of the company, s this will ensure they continue to be paid (rather than have to find a new job when the company fails).

(vii) In view of the planned high borrowings, and future trading losses, there is a very serious risk the company may not be a going concern. This increases the risk of my firm being sued for negligence. Also, Phones Anywhere will put severe pressure on me to give a completely unqualified audit report. This pressure will increase because my audit firm is small and Phones Anywhere is a relatively large and rapid growing company.

(viii) As an alternative to the company not being a going concern, there is the risk that other investors may purchase more shares in the company (to provide additional equity fiancé) or preaches the company outright from the existing directors(or the administrator/liquidator). If this occurs, recent financial statements will be subject to close scrutiny. The standard of audit work will have to be high, and the problems mentioned above (e.g. complex computer systems and depreciation rates which may be inaccurate)could lead to undetected material errors in the financial statements. Thus, there is a high risk that legal action for negligence could be taken against my audit firm following a take over or purchase of shares.

(ix) Floatation of the company on the London Stock Exchange is a further risk. Immediately prior to the floatation, the audit work carried out by my firm will be subject to close scrutiny. So, I will have to be very careful in my work which would increase the cost of the audit and reduce its profitability. Also, when the company becomes quoted on the London Stock Exchange, it is probable I will e replaced as auditor, as my firm will be 'too small'. Almost all of the companies quoted on the London Stock Exchange are audited by one of the 'big 6 firms'.

(x) This is a high technology industry. The technology or customer requirements may change, which could make parts of the equipment obsolete. Alternatively, it could be expensive to modify the equipment or software to meet the demands of subscribers. Is the company currently providing a similar range of facilities to other mobile phone companies. If its service is not as comprehensive as other mobile phone companies, it may not be successful in breaking into the market.

(xi) This appears to be a very competitive industry. Are the competitors profitable, or are they making losses to keep prices low to prevent other companies entering the market? Establishing Phones Anywhere as a major

company in the market will probably require large expenditure on advertising and offering new subscribers a service at a lower price than competitors. Both of these factors will tend to make Phones Anywhere unprofitable (as note (j)in the question suggests).

(xii) I will have to consider the reputation of the three major shareholders and the executive directors. If they have been directors of companies which have failed or been involved in financial or other wrongdoings, this will increase the inherent risk. The reputation of the financial director and the quality of the accounting records are other factors which will have to be considered.

(b) The professional and ethical matters I will have to consider will include:

(i) The size of the audit fee. The rules by professional conduct say the fees for audit and other recurring work paid by one client should not normally exceed 15% of the gross practice income (and 10% for listed and other public interest companies). If the planned audit fee is over 15% of the current practice income I should not accept the audit.

However, the rate of expansion of Phones Anywhere will probably be much greater than the increase in one of my practice, so the 15% rule may become a problem in the next few years. When Phones Anywhere must be less than 10% of the fees of the practice. It seems probable that this limit of 10% will be exceeded. In practice, it is undesirable for the audit fee to approach 15% of the practice income, as reliance on such a large audit fee to approach 15% of the practice income, as reliance on such a large audit fee could be seen to affect my firm's independence.

(ii) My audit firm may be able to audit Phones Anywhere at its current size. However, when the system covers all towns with a population of over 250,000 on occasions audit work will probably have to cover all areas of the country, and it is most unlikely that my audit firm will have sufficient staff to perform this work.

(iii) Whether my firm is technically competent to perform the audit, and whether the size of the firm being audited is too large for the experience of my practice. Mobile telephone companies are very complex and have specialized accounting procedures, both in terms of the accounting system and the way matters are treated in the financial statements (e.g. the advance payment of Kshs.200 given towards the purchase of phones purchased by new subscribers). My firm will probably not have experience in auditing the computerized accounting system which controls calls and generates bills for subscribers. This requires specialized computer auditing techniques.

Also, my firm will be unfamiliar with many of the accounting treatments for fixed assets and they will probably not be able to decide whether the lives given to fixed asses are reasonable. This lack of experience will probably mean that the audit will be too high a risk for my audit firm (i.e. my firm's inexperience will mean that a satisfactory audit control cannot be carried out, so there will e a high risk of material misstatements in the financial statements, which increase the risk of litigation being brought against me)

(iv) I will have to consider whether I have adequate Professional Indemnity insurance (PII) cover. This is unlikely in view of the size of Phones Anywhere so there will be an increased cost of obtaining more PII cover. The insurance

company may refuse to increase my firm's PII cover, because they perceive this is a high risk audit which is exacerbated by the small size of the firm.

Other matters I will have to consider will include ensuring:

1. Partners of my audit firm have no family or perusal relationships with the directors of Phones Anywhere. These relationships also apply to any staff involved in the audit. Ideally, no member of my firm should have relationships with the directors of Phones Anywhere.

2. No-one in the audit firm should own shares or any investments in Phones Anywhere.

3. No-one in the audit firm should be a beneficiary or trustee of a trust which holds shares in Phones Anywhere. The rules of professional conduct do allow employees of the audit firm to be a beneficiary of shares in an audit client, but that employees must not be employed on the audit of that client. For trustees, the trust should hold less than 10% of the shares of the company and the value of the shares should be less than 10% of the total assets of the trust.
4. Employees and partners of the audit firm must not vote on the appointment, removal or remuneration of a firm which is an audit client.

5. The audit firm should not make a loan or accept a loan from an audit client (exception to this rule apply where the audit client is a bank or other financial institution which does not appear to apply in this case).

The audit fee has been considered earlier in this section. However, the audit fee should be sufficient for my firm to perform the audit to a satisfactory standard. Thus, it would not be acceptable to offer a very low fee (often called 'low balling') in order to obtain audit, as this would impose pressure on the time allowed to carry out the audit. This could lead o inadequate work being carried out which would increase the risk that material misstatements in the financial statements may not be detected.

Other matters covered by the rules of Professional Conduct include:

(i) When my audit firm is asked to accept the audit appointment, I must ask the client's permission to communicate with the existing auditor. If this permission is refused, my audit firm should decline to accept appointment as auditor.

(ii) My audit firm should write to the existing auditor requesting all the information which ought to be made available to decide whether or not to accept the audit appointment.

(iii) My audit firm should consider the reply from the existing auditor. If adverse comments are made by existing auditor, I will have to consider whether to accept the audit appointment.

(iv) If the existing auditor does not reply t my firm's letter, a further letter should be sent giving notice (e.g. seven days) that no reply is received in that time, it is understood that there are no professional or other reasons preventing my firm form accepting the audit appointment.

(v) Before finally accepting the audit, my firm should prepare a letter of engagement and ask the directors of Phones Anywhere to sign it.

(c) **From the discussions above, my firm should not offer itself nor accept the appointment as auditor of Phones Anywhere. The main reasons for this decision are:**

(i) Phones Anywhere appears to be too large a company for my firm to audit, and if is likely to grow faster than my audit firm. The audit fee will probably exceed the limit of 15% of the practice income, and if this is not exceeded now, it is likely to be exceeded in the next few years.

(ii) Phones Anywhere is a specialized company with complex computer systems. It is probable my firm will not have the skills to perform this work.

(iii) The accounting conventions for Phones Anywhere will probably be unfamiliar to my firm, particularly the treatment of the Kshs.200 given to new subscribers to purchase the phones and the lives of the fixed assets. I will probably not have the skills to consider whether these treatments are satisfactory and this could lead tome not detecting material misstatements in the financial statements.

(iv) Phones Anywhere appear to be undercapitalized. Currently, gearing is 20% but this will increase substantially with expansion of the network and losses in early years of trading. Thus, there is a serious risk that Phones anywhere will fail or be taken over, which could result in my firm being sued for negligence.

(v) The large size of Phones Anywhere and the small size of my audit firm could compromise the independence of my firm. Third parties (including shareholders) will perceive my firm is not independent (on the relative size criteria), and the Phones Anywhere could bring severe pressure on my firm which would be hard to resist (i.e. they will ask for an unqualified audit report to be given when I should either give a qualified audit report to be given when I should either give a qualified report or an explanatory paragraphs which mentions going concerns problems).

(vi) The potential listing of the company on the Nairobi Stock Exchange increases the audit risk, as there will be greater scrutiny of the financial statements prior to listing, which could highlight problems in the financial statements.

(vii) Finally, because of the large size of Phones Anywhere and the large audit fee, Phones Anywhere may attempt to 'squeeze' the audit fee. I may have to accept this reduced audit fee (as I would be reluctant to lose such a large audit fee) and this could result in a reduction in the time to perform the audit and thus increase the risk of me not detecting material misstatements in the financial statements.

Note: Candidates will be given credit for valid points which are not included in this answer.

ANSWER FOURTEEN

REGULATION AND PROFESSIONALISM

Kenya answer tips

Part (a) is largely factual and tests your knowledge of the current regulatory framework as it applies to fur aspects of auditing. Revise your knowledge on these fundamental areas if necessary – they are al fundamental to your study of auditing.

Part (b) asks you to discuss. Your ideas and views are being looked for here. This type of question shows the importance of students being aware of the debating points affecting the profession – jot down some ideas on this, (what have you covered on your course? What have you seen in the media? What is discussed in your office?) before attempting your answer. Note that his part of the question carries only 8 marks.

The purpose of this question is to examine students on current and potential changes in practice within the profession.

(a)

i) Auditing standards are set by the Auditing Practices Board (APB). The accountants bodies adopt all of the auditing standards promulgated by the APB. Failure by auditors to comply with auditing standards lends them open to disciplinary action by their own accountancy body.

The Companies Act requires the Recognized Supervisory Bodies to have rules and practices as to the technical standards t be applied in company audit work and as to the manner in which these standards are to be applied in practice.

Each Recognized Supervisory Body adopts auditing standards in order to meet the Companies Act requirement, and each body is required to have arrangements in place for the effective monitoring and enforcement of compliance with those standards. Failure to apply relevant auditing standards is a factor which an RSB will take into account when deciding whether persons are fit and proper to be eligible for appointment as company auditor.

ii) Currently the responsibility within a company for the prevention and detection of fraud rests with management. As part of their business responsibilities, the directors of a company have a fiduciary duty to safeguard he assets.

The Cadbury Committee has recently recommended that the auditor should check that the board of a company has established a system which ensures compliance with legal requirements. The auditor is not responsible for preventing fraud but audit procedures should be designed to give the auditor a reasonable expectation of detecting any material misstatements, whether intentional or unintentional in a company's financial statements. This responsibility is set out in SAS 110 Fraud and error (January 1995).

iii) The auditor should always strive to be objective in his professional judgment. He should not only be independent in fact but he must be clearly seen to be independent in practice. The RSDs has no objective in principle to a practice providing services to a client, additional to the audit.

Care must be taken not to perform management functions or make management decisions. The auditor should not assist in the preparation of financial statements for public company clients unless the work is of a routine clerical nature or in emergency situation. Any fee paid to the auditor for non-audit work should be shown in the financial statements in addition to amounts paid for audit work.

Under the provisions of the Companies Act, an auditor may not be an officer or employee of a client company. Thus it is necessary for the auditor to ensure that he does not make executive decisions.

For example if he recruits key financial and administrative staff, it could be construed as the performance of a management function. The auditor's objectivity may be threatened in such situation and he should be careful that he is not seen as acting as anything other than an independent adviser.

iv) Under the Companies Act , a company shall at each general meeting of the company at which accounts are laid, appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next general meeting at which accounts are laid.

Under the 'elective regime' established by the Companies Act 1989 in relation to small companies, a company may elect to dispense with the obligation to appoint auditors annually. In this case the auditor will be deemed to be reappointed for each succeeding financial year on the expiry of the time for reappointing the auditors for that year (unless the company becomes dormant, or the appointment is brought to an end by resolution of the members)

The ethical guidance issued by the RSBs does not specifically deal with the length of audit appointments. However, the auditor should always be aware of any potential threat to his independence which may because by an audit appointment which has lasted for a disproportionate length of time.

(b)

i) Auditing standards are set by the Auditing Practices Board whose members are mainly drawn from the members of the auditing profession. The disciplinary procedures applied against an auditor for non-compliance with an auditing standard are enforced by the professional bodies of accountants. Thus politicians have criticized this self regulatory procedure believing it to be open to abuse and lacking independence.

The argument put forward is that the consequences of auditing affect society and therefore in order to ensure that audits achieve social goals, auditing standards should be set by an independent body.

ii) It is quite apparent from the press and audit research that the public believe that the auditor should and in fact does search for fraud during the conduct of an audit. In view of the recent scandals, particularly BCCI and the Maxwell affair, the public expectation of the extent of an audit has increased.

It is not surprising, given the nature of these scandals that the public finds it difficult to accept that an auditor has no responsibility for the detection and reporting of fraud, especially when one sees the high social cost of these scandals.

iii) Audit firms do not act exclusively in the capacity of auditors for their clients. Audit work is in some cases, not the main business of audit firms. Auditors provide many other services to their clients including tax advice, brand name valuation and recruitment advice.

Audit firms are dependent upon the fees earned from non audit services, and this dependency can affect the auditors' attitude to the audit. If an audit firm loses the audit, the financial loss to the auditors can be significantly more than just the audit fee he provides other services to the client. Thus a significant amount of pressure can be exerted upon the auditor if he supplies other services to the client.

A significant amount of an auditor's fee income derives from non audit work and in an environment where the audit work is declining; fees for other services are becoming increasingly important.

(v) It has been argued that the long term nature of the company audit engagement can lead to a loss in auditor independence due to an increasingly familiarity with the company's management.

In many Europe countries, the audit appointment has, by law, to be terminated after a fixed number of years. If the audit appointment was for a fixed minimum period, then auditors would not be under the same pressure to maintain their client base if they know that their relationship with the company was for a limited period, and that audit appointments would be rotated.

ANSWER FIFTEEN

Impact of e-commerce on audit process

Tutorial notes

1) 'Impact' in the requirement means 'what effect' (if any) – this is reinforced by 'differences in focus' in the quote.
2) In its widest sense the term 'audit process' encompasses the stages of 'engagement/client acceptance', 'planning', 'testing/evidence', 'evaluation' and 'reporting' – thus the one line of the requirement provides a framework for a structured answer.
3) The quote provides further context and clues for a discussion – 'related risks' and 'security measures'.
4) In accordance with guidance on tackling discussion questions candidates would be awarded a mark for any sensible point introducing their answer to indicate why the subject is topical. For example, referring to the recent publication of the International Auditing Practices Committee's Exposure Draft Electronic Commerce Using the Internet or Other Public Networks (Effect on the Audit of Financial Statements).

Given the scope of this Q candidates should neither be surprised nor deterred by the length of this answer!

Engagement/client acceptance
An auditor must be competent to accept/continue an engagement for the audit of the financial statements of an entity engaged in e-commerce. In particular the auditor must have the means to assess the entity's security infrastructure (an aspect of the control environment), evaluate internal controls and carry out detailed substantive procedures.

Knowledge of the business
The auditor's knowledge of the business is fundamental to assessing the significance of e-commerce to the entity's business activities and any impact on audit risk. For example, the auditor should consider whether security issues have been addressed and the way in which:

- e-commerce links to the entity's operating system – e.g. many e-commerce systems on the Internet (on-line 'shop fronts') are not yet linked with the entity's accounting ('back office') systems;
- Internet transactions are captured and transferred to the entity's accounting records. This may affect:

- the completeness and accuracy of transaction recording;
- the timing of revenue recognition;
- recognition and recording of disputed transactions.

The auditor requires appropriate IT skills and Internet knowledge to:
- understand the technology used;
- assess the IT skills of entity personnel;
- adopt a 'through the computer' audit approach (see later).

Specifically, the auditor of an entity involved in e-commerce needs to understand:
- the wide range of risks that exists (e.g. relating hacking, lack of authentication of transactions, transmission failures, loss of trust, theft of customer identity, etc); and
- the systems reliability and preventative and detection controls.

Materiality
The auditor is unlikely to use traditional benchmarks to establish a materiality threshold because:
- materiality is not based solely on quantitative measures;
- qualitative factors may include the assessment of a systems' reliability (where it is as yet unproven);
- the impact of significant risks (see below) arising cannot be quantified in financial terms;
- there may be no performance track record.

Tutorial note: *A profit-based materiality threshold is likely to be inappropriate for a dot.com company.*

Risk assessment
The auditor considers e-commerce business risks in so far as they may impact on audit risk including:
- risks arising from relationships with e-commerce trading partners – this concerns the authenticity of customers/supplies and the integrity of transactions;
- risks related to the recording and processing of e-commerce transactions – e.g. if an unidentified individual can initiate a transaction, or there is a loss of visible evidence ('audit trail');
- pervasive e-commerce security risks (including viruses, hacking and other computer crimes) which impact on the control environment;
- 'denial of service' i.e. overloading the system with spoof orders to bring down the system;
- fraud risks which are increased by the anonymity of customers (similarly money laundering);
- risks of system failures or 'crashes' which restrict access and result in loss of data;
- enhanced going concern risk of companies involved in Internet activity generally and dot.com companies in particular.

The way in which an entity uses IT for e-com, including the entity's assessment of risk and acceptable risk levels in the IT systems, is significant to the security, completeness and reliability of the financial information produced, and therefore affects the auditor's assessment of inherent and control risk.

'Dot.Com' entities
Particular risks relating to dot.com entities include:
- the absence of a traditional asset base;
- the treatment of costs incurred in setting up an infrastructure;
- the need for on-going investment in web technology;
- cash flow forecasts and business plans based on subjective judgments without any proven basis;
- lack of cash flows when business 'takes off' (i.e. over-trading);

- generating intangibles such as brand value and customer service quality;
- market pressures to achieve expectations;
- value added through e-commerce resulting in a market capitalisation which is significantly (sometimes phenomenally!) higher than the book value of the underlying net assets.

Tutorial note: *The market capitalisation of dot.com entities may be based on a revenue multiple where the entity is just a 'middleman' effectively taking a commission on the sale, but showing that commission as revenue less cost of sale.*

For many dot.com businesses (like Amazon.com), the greatest impact of e-commerce is on the sales system. Risk areas will include:

- validity of customers and others;
- creditworthiness and credit card transactions;
- despatching of products.

Going concern

When e-commerce businesses report significant losses in their start-up phase, the appropriateness of the going concern assumption (which underlies the preparation of the financial statements) should be assessed. The auditor should consider:

- the extent to which the losses are due to non-recurring transactions and events;
- cash flow and break-even forecasts;
- the entity's business plans (e.g. to further extend operating activities – e.g. into warehousing and distribution);
- whether financial arrangements are adequate to ensure the viability of continued operations.

Controls

Internal controls seek to ensure that transactions are authorised and correctly (i.e. completely and accurately) recorded and that assets are safeguarded. The nature of e-commerce transactions demands that controls are more sophisticated and extensive (e.g. encompassing data privacy). Security measures aimed at ensuring transaction integrity include:

- encryption i.e. scrambling into code which can only be decrypted with the right key;
- hash values i.e. a total of fields to check that numerical values in a transaction have not been tampered with;
- digital signatures – verify that transaction has been sent by an authorised user;
- 6-8 digit passwords of alpha-numeric combination;
- bio-metrics i.e. physical attributes (e.g. thumbprints, voice recognition, retina scans);
- transaction certificates – typically obtained by a consumer and presented electronically to a supplier who checks its validity with the provider of the certification service.

Systems' failures

Systems' failures (both at the entity and for outsourced functions) can affect the entity's reputation and result in a potential loss of customers, with a significant impact on profit. The auditor considers the entity's contingency and business continuity plans.

Evidence

In contrast to traditional businesses which focus on controls relating to each stage of transaction recording, system controls for e-commerce focus on transaction execution (e.g. fulfilling a customer order). The auditor must obtain evidence of both the design and operation of controls relating to transaction execution to ensure that:

- fictitious or multiple identities are identified (i.e. authentic customer);
- customers browsing and those placing orders are distinguished;
- input is validated and duplication or omission of transactions is prevented;

- terms of trade are determined at the same time the order is processed (this may require that payment is collected when an order is placed);
- causes of transaction failures (e.g. credit card authorisation failure and breaks in communication) are addressed;
- incomplete processing is prevented (e.g. by rejecting the order).

It is highly unlikely that a 'round the computer' approach will be appropriate as both input of transactions and processing are electronic. Even though physical goods may be dispatched (though not always e.g. software suppliers) there is typically less conventional external audit evidence and the traditional audit 'paper trail' is virtually eliminated (e.g. on-line customer orders and confirmation thereof).

Audit trails including access and transaction logs may deter and detect unauthorised users and rogue transactions. Although entities may not have automatic access to these and other 'unusual activity' logs, service-level agreements with the ISP (Internet Service Provider) may provide for them to be retrieved on demand for audit purposes.

Electronic records can be more easily destroyed or altered than more robust physical records (without leaving evidence of such destruction or alteration). Therefore the auditor must assess whether security of information policies and security controls are adequate to prevent unauthorised access or changes to the financial records. Particular consideration should be given to:

- the controls incorporated in system design to ensure data integrity (e.g. record integrity checks, electronic date stamps using digital signatures, version control of electronic evidence, etc);
- controls over the data interface (between front and back office systems);
- controls over real time requirements (e.g. to provide a buffer between transactions processed on the Internet and existing operating systems);
- the accessibility, integrity and retention of e-com records.

Computer assisted audit techniques

File interrogation software (which accessed the entity's data and master files) may be used to examine all (rather than a sample of) items in a population. Files on on-line systems may be interrogated using interactive enquiry software.

Analytical procedures

Analytical procedures must be used at the planning and overall review stages. However, their use as substantive analytical procedures may be limited as traditional relationships (e.g. between transaction and account balances) may no longer be appropriate.

A significant factor in the use of analytical procedures is the extent of disintermediation (i.e. direct connection of producers and consumers to eliminate such middlemen as wholesalers, distributors and retailers). This may affect, for example:

- levels of inventory held (if any);
- the nature of customer accounts (e.g. individuals rather than retail or wholesale).

Also, the comparability of balances with prior periods may be affected by the reliability of the data produced. Particular difficulties may be encountered in obtaining relevant data and identifying related party transactions.

Internal audit

Where an e-commerce business has an internal audit department, the external auditor should seek to place reliance on the work of internal audit (relating to the assessment of risks and evaluation of internal controls).

Specialists
The auditor may require the skills of a specialist to make appropriate inquiries and to understand the implications of responses obtained. For example, rapid changes in the Internet may result in different interactions of evolving technologies and processes. Similarly the auditor needs to recognise whether the entity is developing incompatible or redundant technology. It may be appropriate to engage an IT specialist (e.g. where the audit practice does not have access to the necessary skills inhouse).

Service organisations
Entities which do not have the technical expertise to establish and operate a website providing e-commerce may outsource their web operations to a third party (e.g. to take orders and payments).

The auditor should (ISA 402):

- consider how the service organisation affects the accounting and internal control systems in order to plan an effective audit approach;
- obtain sufficient understanding of the accounting and internal control systems, assess control risk, etc (assuming the service organisation's activities are significant to the entity and relevant to the audit).

Specifically, the auditor needs to understand the contractual terms of relevant activities (e.g. what recourse does the entity have in the event of non-supply of services).

Seals of approval
When an entity's website displays a seal demonstrating compliance with the standards of the seal provider, the auditor must understand what assurance the seal does and does not provide. It is likely that if a seal requires regular verification (e.g. WebTrust) the audit practice has been involved in the awarding of the seal. The auditor will need to be familiar with the security and privacy issues and relevant internal controls when planning the audit.

ANSWER SIXTEEN

1 Alakazam

(a) Potential risk areas

Tutorial note: *A tabular format has NOT been used because, although it is sometimes appropriate and can create the*
impression of a logical answer, it is not always suitable. A columnar approach is inappropriate unless there is a close (e.g. oneto-one) relationship between what is being put into the columns. This suggested answer demonstrates the higher skill of considering the risk areas collectively in planning the audit approach.

Chief executive
As chief executive, Leon Izzardo holds a dominant position and the recent success (expansion) of Alakazam may be largely attributable to him. The appropriateness of the going concern basis may be questioned if Leon were to leave (say before the WAP phone rights are renewed or a replacement product found).

Also, the need for funds to finance the ongoing expansion may create management bias to overstate the company.s profitability (e.g. by understating amortisation of distribution rights, warranty provisions, etc).

Growth
Sales growth, resulting from the purchase of distribution rights, has resulted in business expansion (increasing the workforce and requiring new premises). All of which requires financing. There is a possibility that Alakazam is overtrading (i.e. entering into commitments which exceed its available short-term resources).
Accounting and internal control systems
The increase in administrative and accounts staff will facilitate greater segregation of duties and this should reduce control risk. It is expected that head office will have implemented new/improved control procedures, for example:
- centralised purchasing (implied by central distribution);
- centralised payroll; and
- credit control (new customer accounts).

However, the incidence of errors arising may be increased, as compared with last year, if the rapid expansion has put the accounts departments under pressure such that existing internal controls have lapsed. Also, errors arising may not be detected if, for example, new accounting staff have insufficient training or experience.

Product
Alakazam is heavily dependent on just one product to which the company has distribution rights for less than a year (say nine months) from now.

Inventory could be overvalued due to:
- a reduction in price (if product has to be sold more cheaply to maintain sales volume/market share);
- falling demand if the market is saturated;
- manufacturing defects;
- technological obsolescence/new models being introduced by a competitor.

Trade receivables
Trade receivables could be overvalued as the risk of bad and doubtful debts may be increased due to:
- laxity in creditworthiness checks (in the drive to expand the customer base);
- disputes arising from the manufacturing defects.

Liabilities/Contingencies
Liabilities associated with expenditure on sales warranty work may be understated, for example, if their extent as at the year end is not ascertained.

The financial statements could be materially misstated in respect of contingencies or post balance sheet events if they are not properly accounted for. In particular:
- adequate provision should be made for sales warranty work;
- contingent assets (e.g. if there is recourse to the supplier of the WAP phone over defects) should be disclosed;
- disputes with customers and the WAP phone supplier (over defects) resulting in litigation may require provision and/or disclosure of contingent liabilities.

Going concern
The going concern basis may not be appropriate because:
- the future of the company may be dependent on Leon Izzardo;
- working capital may be inadequate to deal with overtrading;
- the scale of operations is dependent on one product (the WAP phone) and supplier;
- sales are falling;
- manufacturing defects may result in loss of sales/customer goodwill.

Intangible assets
Intangible assets and profit for the year may be overstated in respect of any carry forward of distribution rights capitalised last year. Amounts involved are likely to be material and management will probably be biased in favour of carry forward (e.g. amounting to 6/24 × cost). This will be imprudent if, for example, future sales of the WAP phone are in doubt and the value of distribution rights is impaired.

Conclusions
Inherent risk is high as the financial statements may be materially misstated due to the likelihood of errors arising and the high degree of subjectivity involved regarding accounting matters (going concern, warranty provisions, inventory valuations, intangible assets, etc).

Control risk is likely to be low in some areas (e.g. purchases) but potentially higher in others (e.g. inventory).
To render detection risk low will require a substantive approach to the higher risk and judgemental areas (e.g. inventory valuation, warranty provision) though reliance will be placed on controls if appropriate (e.g. purchases and payroll).

Additional point
Foreign currency exchange risk arises on imported goods.

(a) Audit strategy
Obtaining information
The permanent audit file should be updated in respect of:
- new premises purchased/rented;
- loan creditors/financing arrangements;
- significant new customers;
- new appointments of key personnel (e.g. in administration, servicing and distribution);
- changes in the accounting and internal control systems.

Recording the system
Changes in the accounting system and internal controls may have been made piecemeal during the expansion and possibly informally and without adequate documentation.

It may be appropriate to make a new record of the systems rather than amend prior year narrative notes. Flowcharts could be prepared in respect of those parts of the system which are established and likely to remain so. The ongoing expansion and possible need to accommodate changes should be borne in mind.

Materiality assessment
Monetary materiality is likely to be much higher for the year to 31 March 2002 than for the prior year given:
- WAP phone sales for a whole year (prior year only six months);
- doubling of customer base;
- trebling of workforce;
- new premises.

Tests of control
Effective controls will be relied on where tests of control and reduced substantive procedures are, in combination, more efficient than a wholly substantive approach. Areas in which this is most likely to be appropriate include:
- purchases;
- payments to suppliers;
- payroll costs;

- receipts from retailers (trade customers).

Accounting policies
The appropriateness of capitalising distribution rights (assumed) must be substantiated by:
- agreeing client's schedule of costs to supporting invoices;
- discussing, with management, sales forecasts;
- monitoring after date sales of the WAP phone.

Attendance at year-end physical inventory count
To confirm the accuracy of recorded quantities, the physical count will be attended at the central distribution department. Particular attention will be given to:
- the quantity and condition of phones held in the servicing department;
- any deliveries accepted during the count; and
- the clients procedures for despatches to retail outlets during the count (if any).

Analytical procedures
Although the expansion of operations will significantly distort account balances with the prior year there will be scope for analytical procedures. In particular, the material correctness of recorded sales other than the WAP phones may be substantiated by a month-on-month comparison of turnover and review of gross profit margins.

The reasonableness of payroll costs may be ascertained by inflating prior year employee costs, by department (sales, distribution, servicing, administration), for the increase in the number of employees.

Trade receivables
A year-end circularisation of retailers will probably reveal disputed amounts in respect of defective products. The adequacy of Alakazam.s provision for after date credit notes must be carefully monitored. The recoverability or otherwise of accounts in dispute should be confirmed by vouching receipts of after date cash.

Controls over acceptance of new customers should be reviewed to ensure creditworthiness checks are being performed as customer base increases.

Warranty provision
In addition to providing for credit notes issued to customers (in respect of faulty goods returned), provision should be made for costs incurred by the servicing department after the year end for phones sold prior to the year end.

It is likely that the client will not have much experience in exercising judgement in this area and may therefore be looking for guidance. Reliance on management representation, as to the adequacy of the provision, may therefore be inappropriate.

Legal advice
Communication with the company's legal adviser and possibly, also, an independent lawyer should be established as specialist evidence may be required in respect of:
- the legal interpretation of the agreement with the manufacturer especially regarding the defects;
- the legal interpretation of the conditions of sales warranty;
- legal opinion on the outcome of any litigation with the manufacturer or customers.

Bank/loan creditors
Confirmations will be required, so details of the company's bankers and other providers of finance must be ascertained in good time before the year end. Specifically, care should be taken to ensure that information is obtained on the following:
- title deeds held (e.g. to head office premises);

- dates planned for review/renegotiation of facilities;
- bills of exchange, letters of credit or other means of settling amounts due to the overseas supplier.

Discussion with management
Matters to be discussed with management include:
- developments in financing negotiations;
- basis of preparation and assumptions used in forecasts;
- whether Alakazam is involved in any litigation.

Assuming that there is no conflicting evidence that contradicts management.s representations, it may be appropriate to obtain written management representations.

Additional points
Substantive procedures on the inventory valuation should be aimed at ensuring the adequacy of the provision for slow moving, obsolete and faulty items.

A 'hot review' of the audit files should be scheduled given the high inherent and failure (i.e. going concern) risks associated with Alakazam.

(b) Proposed acquisition of Neodex

(i) Matters to be considered

Tutorial note: *As the requirement did not specify the nature of the principal matters to be considered (e.g. financial, operational, strategic) there is a lot of scope for just 5 marks. What is important, is that they should be matters considered by the acquiring company.*

- Whether the planned .acquisition. is:
- for a controlling interest or 100% ownership;
- of Neodex.s shares, its business or its assets (see below). (Consolidated group accounts will have to be prepared if Neodex is acquired as a subsidiary.)
- The eagerness of the two parties to proceed with the negotiations. Alakazam is the company making the moves to acquire Neodex and the directors of Neodex may therefore have the .upper hand. in negotiating an acceptable offer price.
- Stefan and Georgio are relatively young and perhaps lacking in business acumen. Stefan, in particular, may be keen to see the DINS exploited by Alakazam for a faster and greater return than they could achieve on their own.
- What is it that Leon Izzardo is trying to acquire for Alakazam? One motive for the acquisition is likely to be the DINS (and possibly Stefan.s new design). To secure new designs, the expertise of Stefan must be retained (e.g. by offer of share options) and motivated (e.g. by profit-related pay).
- Agreement must be reached with both shareholder-directors to acquire (at least a controlling interest in) the company. To buy all Neodex.s shares, the same offer may need to be made to both directors.
- Stefan may perceive his shareholding to be the more valuable (because of his intrinsic value to the company as the technical/design director). The offer to Stefan could be differentiated from that to Georgio Neratu by leaving Stefan with a shareholding.
- Benefits of synergy are unlikely to accrue (e.g. economies of scale) as Neodex is so small in all respects (e.g. assets,employees) in relation to Alakazam. However, there may be an opportunity to insource the manufacture and assembly of circuit boards.
- The form in which Stefan/Georgio will require consideration (e.g. cash and/or shares).
- The amount of investment needed in advertising DINS (and how soon) in order to increase sales.

- If substantial, cash (for consideration and a major advertising campaign) may have to be diverted from existing projects or raised from external borrowings.
- The acquisition may facilitate diversification and further growth if Stefan.s prototype is successful.
- Whether any interest in acquiring Neodex, rights to DINS or Stefan has been expressed by any other party.
- Given the recent fall in Alakazam.s WAP phone market, Alakazam is actively seeking opportunities to expand (and thereby reduce the risk of business failure).

Additional points

- Existing contractual arrangements for outsourcing of the circuit board . whether the supplier can meet increasing volumes. (Also the reliability of the supplier.)
- That Neodex is a new company which does not yet have a .name. will be reflected in the purchase price (i.e. lower).
- An assessment of demand for DINS needs to be made to confirm the potential for increased sales.
- An acquisition at this time could further increase the risk of company collapse (i.e. by adding further financial proessure to overtradingg, product defects, etc).

(ii) Implications of acquisition for conduct of audit

As Neodex is so small in relation to Alakazam it is unlikely that there will be a significant impact on the resources (staff, time, etc) required to complete the audit. However, if Neodex is acquired as a subsidiary, Alakazam will need to prepare consolidated accounts. Assuming that the audit of Neodex is also transferred as a result of the acquisition, there will also be a need to liaise with the previous auditors (.professional etiquette.).

Tutorial note: *Preparation of consolidated accounts may be for the first time as there is no reference in the Q to the existence of other group companies.*

The fair value of the tangible assets acquired (probably not much more than assembled units DINS and unassembled components) is likely to be significantly less than the purchase consideration. If fair value can be determined for development expenditure (e.g. in respect of the design of DINS and the new prototype) that meets the criteria for recognition as an intangible asset, it should be capitalised and amortised (rather than subsumed within goodwill on acquisition).

Assuming the acquisition takes place in early 2002, post-acquisition results will be immaterial to the consolidated income statement (to 31 March 2002). It is likely that Neodex will require audited financial statements for the 15 month period to 31 March 2002. If Neodex.s current auditors are retained (unlikely), the extent to which reliance can be placed on their work must be assessed.

Most of the background information required to plan the audit of items relating to Neodex will have already been obtained during the pre-acquisition review work. A substantive approach to relevant account balances (e.g. inventory of DINS) will be adopted as Neodex did not have systems suited to tests of control.

As Alakazam needs to invest heavily in promoting DINS, advertising expenditure around the year end may be material (some of which may be prepaid).

The acquisition of Neodex (i.e. DINS) may be a mitigating factor when assessing the doubts surrounding the going concern status of Alakazam.

Additional point

- As increased audit work will result in some increase in audit fee, the total recurring fee for Alakazam should be reassessed. If it now exceeds 10% of gross practice income the assignment should be kept under review and additional safeguards put in place (e.g. files subjected to a second partner review).

ANSWER SEVENTEEN

3 SIEGLER

Tutorial notes

(1) Matters' will often encompass considerations of 'risk', 'materiality' and 'accounting treatment'(i.e. the omission of recognition and/or disclosure as well as benchmark and alternative treatments).

(2) Many points can only be made as either 'matters' or 'audit evidence' (and there is no 'one-for-one' relationship between the two that would warrant a columnar approach). However, some points could be made as either or both – although the emphasis would need to be different. For example, a matter to consider in (1) is the terms and conditions of the grant which may provide evidence of the likelihood of the grant being repaid, whilst the evidence will be documentation to and from the government (e.g. grant application form or contract).

(1) Government grant

(a) Matters

The grant represents 17·4% of profit before tax, 17·8% of intangible assets and 1·7% of total assets and is therefore material. Intangible assets (before deduction of the grant) constitute 9·7% of total assets and are therefore material also. Receipt of a grant does not itself provide conclusive evidence that any conditions attaching to it have or will be fulfilled.

The most appropriate accounting treatment of the grant depends on whether or not it:

- relates to asset(s) or income;
- has been made for past or future expenditure;
- has (or will) become repayable.

If the grant related to assets it should be presented in the balance sheet either as deferred income or by a deduction from the carrying amount of the assets. A grant relating to income should be credited to the income statement (IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance').

Siegler's treatment suggests that the grant relates to the asset of development expenditure which has been recognized as an asset and therefore incurred. However, if it was granted for the future operation of a pilot plant it should be deducted from expenditure not yet incurred (e.g. on the specialist equipment ordered for the pilot plant). Therefore, it should be shown as a deferred credit.

The reason for the order for specialist equipment being cancelled – whether it was instigated by Siegler or the supplier. Siegler may incur penalties if the contract was cancelled by them (or be able to claim compensation if cancelled by the supplier).

There is evidence to suggest that the pilot plant may not come into operational existence (i.e. the order for specialist equipment has been cancelled and research activities are being directed from bio-technology to another technology). Ifthe terms and conditions attaching to the grant which was applied for and received are not met it may be repayable.

To the extent that the grant has become repayable (assuming it relates to an asset) the carrying amount of bio-technology development costs should be increased and a liability recognised.

Siegler's plans for using the patented bio-technology appear to have changed and the carrying amount included in intangible assets may be impaired. The recoverable amount of the intangible asset arising from the development of the bio-technology should be assessed (IAS 36 'Impairment of Assets'). If Siegler now has plans to sell rather than use this technology it may be possible to determine a net selling price.

If the intangible asset is not yet available for use it should have been reviewed for impairment at 30 June 2002 (IAS 38 'Intangible Assets').

(b) Audit evidence

- Receipt of Shs. 800,000 in May 2002 – confirming the amount recognised.
- The bank report for audit purposes if the grant is still held (e.g. in a separate bank account) to be expended.
- The terms and conditions of the grant set out in the application for the grant or government contract received including:
  - pre-conditions (e.g. if Siegler was to have already placed an order or contracted for the specialist equipment before being entitled to receive the grant);
  - any 'proofs of purchase' or similar which may be required to be sent to the government agency as and when expenditure is incurred;
  - any obligations of Siegler to declare any breach in their undertakings.
- Correspondence with the relevant government agency (e.g. if repayment of the loan has been requested).
- Any penalties incurred, and by whom, as a result of the order for specialist equipment being cancelled.
- The repayment, if any, of part or all of the grant since 30 June 2002.
- Legal advice on the terms and conditions of the grant and whether, for example, repayment can be enforced.
- Management representation confirming future plans for Siegler's activities.

(2) Contaminated land

(a) Matters

The cost of the land represents 1·6% of profit before taxation and less than 0·2% of total assets and is therefore not material (e.g. if the value of the land is so impaired that an impairment loss should be recognised amounting to the whole of its cost).

The provision represents 21·7% or profit before taxation and 2·2% of total assets and is therefore material.

The reason for the closure and demolition four years ago – whether Siegler knew about or suspected the contamination.

The reason for recent testing by the water authority (e.g. whether routine inspection or in response to concerns about public health and safety).

A provision should not be recognised unless there is:

- a constructive obligation to clean up the land (because there does not appear to be any legal obligation to do so); and
- a reliable estimate of the obligation can be made.

There will not be a constructive obligation unless, for example, Siegler has a published policy for cleaning up sites and honouring its published policy (i.e. creating a 'valid expectation'). If Siegler has a published policy and knew or suspected contamination of this site, the fact that it has taken four years to do anything about remedying it may suggest that it does not honour its policy (and therefore that a provision should not be made).

Whether now, more than four months after the findings, any action has been taken by Siegler's management to carryout a clean up operation (e.g. whether outside waste management contractors have been asked to tender for it).

How $1 million has been estimated (e.g. from tenders or the report of an expert) and how it is to be financed.

Whether the results or the timing of them had any bearing on the facts of (1) – e.g. if financing the clean-up creates a lack of finance for the pilot plant.

Tutorial note: *Under IAS 16 and 37 a provision for 'decommissioning' (or similar) which is a liability may be debited to*
the cost of an asset on initial *measurement. However, as the asset (land) is carried at cost and subsequent expenditure on a clean up operation should be recognised as an expense (IAS 16) the provision has been charged to the income statement in the current year.*

(b) Audit evidence

- The conclusions and recommendations (if any) of the local water authority's report.
- A visit to the site – is it wasteland? Has a clean-up operation commenced?
- Board minutes documenting the need for and approval of a clean-up (e.g. if the land is to be sold)
- Any plans drawn up for permissions to develop the site.
- Prior year financial statements – whether the matter (of contamination and potential liability) has previously been disclosed.
- Any tenders invited or received or contracts entered into for a clean-up operation.
- Published environmental policies and/or costs incurred in past clean-ups (documented in prior year working papers).
- Written representations concerning management's intentions to undertake the clean up.

(3) Investment properties

(a) Matters

The Shs.3·3 million 'revaluation surplus' represents 7·1% of total assets (and 71·7% of profit before taxation) and is therefore material.

What has prompted this first time valuation of the apartment block and what is the reason for not having valued the office block at the same time?

Carrying an item of property at a revalued amount with the surplus being credited directly to a revaluation surplus within equity is the allowed alternative treatment under IAS 16 'Property, Plant and Equipment'. IAS 16 requires that all assets within a class be revalued simultaneously in order to avoid selective revaluation of assets (and the reporting of amounts in the financial statements which are a mixture of costs and values at different

dates). If it was management's intention to adopt the allowed alternative treatment, all other land and buildings (including head office, contaminated land, etc) should have been revalued within a short space of time of 30 June 2002.

However, the apartment block and office block are not owner-occupied but held to earn rentals and therefore investment properties. Investment properties should be accounted for under IAS 40 'Investment Properties' not IAS 16. (All other properties may, however, be valued under the IAS 16 benchmark treatment and not be revalued.) IAS 40 does not permit selective revaluation and all Siegler's investment properties should be measured under either:

- the fair value model; or
- the cost model (i.e. the benchmark treatment of IAS 16).

The fair value model cannot be said to be adopted if the office block is not revalued.

It is likely/possible that the carrying amount of the office block is impaired (and that a valuation would be lower) given the difficulty which Siegler seems to have in letting out office space.

Under IAS 40 gains and losses arising from a change in fair values should be included in net profit or loss for the year in which they arise. However, assuming that the office block will also be revalued, this is the first year in which IAS 40 is adopted. If Siegler previously disclosed the fair values of these properties (i.e. in the notes to the financial statements as at 30 June 2001), then the comparatives can be restated and the opening balance of retained earnings adjusted. If fair values have not previously been disclosed, the comparative information should not be restated (i.e. the net gain/(loss) will be included in net profit of loss for the year to 30 June 2002).

(b) Audit evidence

- Physical inspection of the location and condition of the apartment and office blocks. Confirm that the office block is not owner-occupied (in the light of low tenancy).
- The information in the valuer's report including the date of valuation, bases used (e.g. open-market), assumptions made (e.g. full occupancy), etc.
- The qualifications, experience and objectivity of the valuer.
- Discussions with management/board minutes to ascertain the reason for the revaluation.
- Management's impairment review, if any, of the office block.

ANSWER EIGHTEEN

3 Visean

Tutorial notes

(1) 'Matters' will often encompass considerations of 'risk', 'materiality' and 'accounting treatment' (i.e. the omission of recognition and/or disclosure as well as benchmark and alternative treatments).

(2) Many points can only be made as either 'matters' or 'audit evidence' (and there is no 'one-for-one' relationship between the two that would warrant a columnar approach). However, some points could be made as either or both – although the emphasis would need to be different. For example, a matter to consider in (1) is the fall in demand which may provide evidence of impairment, whilst the evidence will include the level of after-date sales, by month, by fragrance.

(1) Brand names

(i) Matters

'Ulexite' is one of the four purchased brands and therefore has a net book value in the balance sheet.

The cost of the purchased brands represents 3·2% of total assets and 32% of PBT (net book value will be less). Annual amortisation amounts to 3·2% of PBT. Brands as a whole are therefore material. If the net book value of 'Ulexite' at the year end is greater than Shs. 91,500 (i.e. 5% PBT) its total write-off (e.g. due to impairment) is likely to be regarded as material.

The fall in demand in January 2002 is an adjusting post balance sheet event (IAS 10 'Events After the Balance Sheet Date') providing evidence about the valuation of assets as at 31 December 2001 as a result of the marketing campaign. In particular:

- the net realisable value of inventories of 'Ulexite' products may be less than cost;
- the value of the brand name 'Ulexite' itself may be impaired;
- by association, the value of other brand names and their associated products may be similarly affected;
- there could be loss of customer goodwill to Visean as a whole if, by the association of 'Ulexite' with Visean, there is a boycotting of Visean's products (as has been the case with Benetton and Nestlé).

Each purchased brand is likely to be regarded as a cash-generating unit as the revenues flowing from each brand are largely independent of each other (IAS 36 'Impairment of Assets'). Also, decisions can be made about individual fragrances (e.g. to discontinue use of the 'offending' fragrance). It is likely that the recoverable amount of an individual purchased brand name can be assessed.

Whether management consider the 'Ulexite' brand value to be impaired and, if so:

- the amount they propose to recognise as an impairment loss; and
- how the recoverable amount (the higher of net selling price and value in use) has been determined.

Net book value of 'Ulexite' as at the year end will provide a 'ceiling' for the amount of any impairment loss recognised.

What action, if any, management propose to take (e.g. to discontinue the fragrance, sell the name or promote it).

If management is taking legal action against the advertising consultants (if external to Visean) – there may be a disclosable contingent gain.

Whether 10 years is a reasonable period over which to amortise purchased brand names. It is appropriate that the straight line method should be used (as an alternative pattern of consumption of economic benefits cannot be determined reliably) – IAS 38 'Intangible Assets'.

(ii) Audit evidence

- Year-end cost/net book value of 'Ulexite' agreed to prior year working papers, less current year's amortization charge.
- Analytical review of actual after-date sales (and/or inventory turnover) against budget, month on month, and by fragrance to identify:
  - the significance of the fall in demand of 'Ulexite';
  - whether other fragrances have been similarly affected;
  - if demand is 'picking up' again (in February to June).
- Monthly sales analysis returns received from retail pharmacies.
- The advert, promotional literature or 'slogan' relating to 'Ulexite' which caused the offence. (And media reports, if any, arising from bad publicity.)
- If the 'Ulexite' brand name has been written down:
  - to net selling price – a binding agreement to sell 'Ulexite';

  - to value in use – cash flow projections for the next five years (or the remaining useful life of 'Ulexite' if shorter).
- Board minutes reflecting any decisions taken (e.g. to discontinue the fragrance).
- Expenses, if any, incurred since April (reflected in the cash book and/or after-date invoices) to rectify the damage done (e.g. a new marketing campaign).
- Amortisation rates and periods used in the 'cosmetics' industry.
- Copy correspondence and notes concerning any pending legal action and possible quantified outcomes.

(2) Discontinued operation

(i) Matters

The provisions have reduced PBT by 40% (i.e. 1·25 ÷ [1·83 + 1·25]) and now represent 68% of PBT and are
therefore considered to be material.

The plan to close the factory facility is likely to result in a discontinued operation if hospital medical consumables are a separate line of business which can be distinguished operationally and for financial reporting purposes (IAS 35 'Discontinuing Operations').

If hospital medical consumables were reported as a business segment in the notes to the financial statements for the prior year (under IAS 14 'Segmental Reporting') this will satisfy the 'separate line of business' criterion.

The initial disclosure event will be the earlier of:
– the directors' announcement in December (that the factory closed in January strongly suggests that a formal detailed plan existed and was approved before it was announced);
– a binding sale agreement for substantially all the related assets (i.e. plant, equipment and inventory – not the factory itself, as it is leased).

Tutor note: *The announcement is the more likely in the context of the given scenario.*

The disposal of any assets (e.g. plant) arising from the factory closure in January is a non-adjusting post balance sheet event (IAS 10) which may require disclosure in the financial statements (if material).
No provision should be made for the loss on sale of related assets after the year end unless a binding sale agreement was entered into before the year end. However:
– factory assets (plant and equipment) should be reviewed for impairment (IAS 36); and
– inventories of hospital consumables should be measured at the lower of cost and net realisable value (IAS 2 'Inventories').

Assuming that the announcement in December raised valid expectations (in employees and customers) that a detailed formal restructuring plan would be carried out, a constructive obligation to restructure arises (IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'). The provision made should include:
– redundancy costs (but not any costs of retraining or relocating continuing staff);
– present obligations under onerous contracts (e.g. for the unexpired lease term on the factory premises).

If products other than medical consumables were supplied to hospitals, Visean may lose hospital customers altogether (as the hospitals turn to other suppliers for the medical consumables).

Tutorial note: *Presumably this was taken into account when making the decision to discontinue the activity.*
Further provision may be necessary for onerous contracts with customers (and possibly suppliers). For example, hospitals (as public sector bodies) are likely to have contracts with Visean containing penalty clauses for non-performance (breach of contract, etc).

(ii) Audit evidence

- Segmental information in the prior year financial statements showing hospital medical consumables to be a business segment (e.g. if this activity accounted for 10% or more of Visean's turnover, result or net assets).
- Initial disclosure of:
  - carrying amounts of assets being disposed of (if any); and
  - revenue, expenses, pre-tax profit (or loss) and income tax expense attributable to the discontinuing of medical consumable supplies.
- Agreement of initial disclosure to underlying financial ledger accounts (management reports, etc).
- Comparison of separate disclosure with budgeted amounts and prior year.
- Board minutes approving the formal plan to discontinue the product range, close the factory and make staff redundant.
- Copies of announcements (e.g. press releases and letters to hospitals (i.e. as customers) and employees).
- The binding sale agreement (if any) for plant, equipment and inventory.
- The contractual terms of the factory lease and correspondence with the lessor (e.g. to negotiate the surrender of the lease, sub-leasing, etc).
- Penalty clauses, if any, in contracts with hospitals (also contracts with suppliers).
- Calculations of the provisions (and assumptions made).
- Redundancy terms for employees (both contractual and statutory).
- Past redundancy settlements (as compared with statutory and contractual obligations).
- After-date sales of hospital medical consumables.

(3) Cash flow statement
(i) Matters

The cash flow statement should be prepared in accordance with IAS 7 'Cash Flow Statements' (i.e. reporting cash flows classified as operating, investing and financing activities) for each period for which financial statements are presented – therefore comparative information is required.

Cash flows from operating activities may be reported using either the 'direct' or 'indirect' methods. IAS 7 encourages reporting under the direct method because it provides information which is not available under the indirect method.
However, as the provision of such additional information may be more time-consuming and costly, the direct method is not required.

Although IAS 7 does not describe it as such, the direct method may be thought of as the benchmark treatment and the indirect method as the allowed alternative. The change in accounting policy from indirect to direct is clearly permitted as it provides more relevant information about cash flows (IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies').

Under the benchmark treatment for changes in accounting policy (other than on adoption of an IAS) comparative information should be restated unless it is impracticable to do so

(IAS 8). It is appropriate that the corresponding figures have been restated. The reason for reclassification should also be disclosed (IAS 1 'Presentation of Financial Statements').

The restatement only affects the amounts which make up cash generated from operations (i.e. a part of 'Net cash from operating activities').

The auditor's responsibility for corresponding figures (ISA 710) is to obtain sufficient appropriate audit evidence that they have been correctly reported and appropriately classified.

The auditor's report should not specifically identify the comparatives because the audit opinion is on the current period's financial statements as a whole, including the corresponding figures.

There should be no specific reference to the corresponding figures in the auditor's report merely because they have been restated (ISA 710). However, if the corresponding amounts have not been properly restated (or appropriate disclosures have not been made – e.g. the reason for restatement) the report should be modified with respect to the corresponding figures.

(ii) Audit evidence

- Agreement of 'Net cash from operating activities' downwards in the cash flow statement corresponding amounts to the prior year cash flow statement in the financial statements.
- For the prior year, agreement (or reconciliation) of net PBT as adjusted for non-cash items (e.g. depreciation) and working capital changes to cash receipts from customers less cash paid to suppliers and employees.
- Schedules of cash receipts (per analysis of cash book receipts) agreed to the receivables ledger control a/c.
- Schedules of cash payments to suppliers and employees (per analysis of cash book payments) agreed to the payables ledger and payroll control a/cs (respectively).
- Analytical procedures such as the comparison of trade receivable (and payable) days (i.e. average credit periods given to customers and received from suppliers) with prior year.

ANSWER NINETEEN

Aventura International

Tutorial note: *The requirement uses the term .the auditor. rather than, more specifically, .Voest. or .the audit team. (say) so that candidates can respond from a wider range of standpoints.*

(1) Goods

If this was the first time that such an offer had been made to audit staff it should not have been accepted during the physical count. Before accepting offers of goods, audit staff should discuss with their superiors (e.g. audit manager) the propriety of doing so. Voest may have a policy not to accept any offer of goods or services on grounds of the threat to objectivity impairment.

Unless the value of any benefit is modest, accepting goods (also services and undue hospitality) may threaten objectivity. 30% of MRP (manufacturers recommended price) amounts to a 70% discount which may not be modest, especially as it has been offered in respect of .any items ...

The modesty, or otherwise, of the offer should have been compared against the staff discount scheme (if any) which Aventura offers to its employees. If Aventura does not offer staff discounts, the offer of discounted goods should have been declined.

Voest could contemplate the audit staff accepting offers of goods on terms no more beneficial than those offered to employees. However, consideration should also be given to whether or not audit staff are likely to take up such an offer (e.g. if fashion designs are for a teenage market). If the offer is attractive, Voest should consider whether accepting it might raise issues for staff planning (e.g. if assigning staff to Aventura might be perceived as a reward or favouritism).

The offer should certainly not be taken up at the physical count as it would contribute to movement (which should be minimised). Also, if it later transpired that there was a problem with the count or the subsequent inventory valuation (e.g. if the audit team failed to identify obsolete or slow-moving items) there would be the risks of:

- claims of negligence (that the audit team were not sufficiently diligent);
- objectivity impairment or even misconduct (the goods might have the appearance of a bribe).

In summary, the offer might be taken up:

- if no more beneficial than to employees; but
- only at a time when it would not interfere with the conduct of the audit; and
- with the approval of the audit partner

(2) Services/Hospitality

Tutorial note: *Although there is some overlap with the nature of the matter in (1), it is a higher skill to be able to raise different points by making distinctions, rather than repeating those points already made.*

Armando has invoiced Aventura for Darius.s holiday flights (implied). Clearly this is not tax allowable business expenditure in the accounts of Aventura (akin to entertainment expenses/hospitality). The value of return flights is unlikely to be regarded as modest (e.g. by less senior members of the audit team and .the man in the street.) . especially if he took his family.

The audit manager should not have accepted the use of the jet without the express permission of the audit engagement partner (and/or partner in the firm responsible for giving guidance on ethical issues).

Darius may have paid for the use of the jet. As the jet is Armando.s, Darius could have paid Armando directly. Armando should not then have raised an invoice to Aventura for re-imbursement as business usage.

Even if an amount paid by Darius represents a commercial rate for the chartering of a private jet, the mere fact that Armando should make it available might suggest a close (business or personal) relationship between them.

If Darius used the jet without the knowledge of Voest
If it has only come to light during the current year.s audit that Darius used the jet (whether or not he paid for it) he should be removed from the assignment immediately. In this event, it should also be noted that the trip was timed before the audit of the prior year financial statements was completed.

All audit work on the financial statements for the year ended 30 June 2001 should be reviewed by a newly assigned manager/partner (even at the risk of not meeting any reporting deadline). Particular attention should be paid to all matters of the audit

manager.s judgement. Even if there is no evidence of the manager.s work having been .slack. in respect of the current year.s audit, it would be appropriate to review how he dealt with any final review points on the prior year audit.

Darius should be asked whether he has used the jet on other occasions (e.g. in September 2001) and this should be confirmed with Armando.

The integrity of Darius as a senior employee of the firm should also be questioned. Darius.s relationships with other clients and assignments should be investigated by Voest.

Tutorial note: *Another .angle. which could be taken on the scenario is that Darius has undertaken a special investigation for Aventura. The issues and actions regarding the provision of other services to audit client will clearly be relevant (and earn marks).*
(3) Ex-audit staff employed by client
As Kirsten was only the accountant in change (AIC), not the audit manager or partner, it is unlikely that a significant lack of objectivity could have impaired the audit opinion for the year ended 30 June 2000. The audit files and financial statements should have been reviewed by the manager and partner in the knowledge that Kirsten was about to leave (if she had not already left).

However the objectivity of the prior year audit may have been impaired if Kirsten already had a personal relationship with Armando before she joined Aventura and while she was still employed by Voest. On being made aware of the relationship (even if it was only last week) the engagement partner/Voest should have arranged for a .cold. second partner review of the audit working papers for the prior year. If there is any possible lack of evidence in respect of a material area, the audit program for the current year should be reviewed and amended (as necessary).

As the former AIC, Kirsten may have close relationships with the audit team conducting the current year.s audit. However, the audit team should have been adequately briefed and be alert to the possibility that she could influence them, however unwittingly (e.g. in simply explaining how she .did things. previously). The extent to which reliance (if any) has been placed on any representations by Kirsten should be reviewed in the light of the announcement.

The audit engagement partner should review the audit strategy (e.g. in terms of its predictability) to ensure that Kirsten.s previous knowledge of it (presumably passed on to Armando) will not impair its effectiveness.

ANSWER TWENTY

FRAZIL

(a) Auditor's responsibilities for reporting on compliance with IFRSs

It has long been established that:

- the auditor's principal responsibility for reporting (generally) is to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an *identified* financial reporting framework (ISA 200 'Objective and General Principles Governing an Audit of Financial Statements');
- the auditor's report must clearly indicate the financial reporting framework used to prepare the financial statements (ISA 700 'The Auditor's Report on Financial Statements'). Specifically, auditor's responsibilities for 'reporting on compliance with IFRSs' are set out in the International Auditing Practice Statement 'Reporting on

Compliance with International Financial Reporting Standards' (IAPS 1014) issued by IFAC's International Auditing and Assurance Standards Board (IAASB).

(i) *Only IFRSs*
The auditor should be alert to indicators of non-compliance. In the event of any material departure the auditor is responsible for giving a qualified 'except for' or 'adverse' opinion, on the grounds of disagreement – unless management changes the accounting policy and/or disclosure, as necessary, in order to comply with IFRSs.

(ii) *Both IFRSs and national standards or practices*
For an unqualified opinion to be justified, the financial statements will need to comply with both frameworks,
simultaneously, without need for reconciliation. (This will be rare. For example, where IFRS has been adopted as the national reporting framework.)

The auditor is responsible for determining which is the predominant framework and encouraging management to report only in that framework. If the problem is not removed in this way the auditor reports on *each* framework (qualifying the audit opinion on at least one).

(iii) *National standards or practices with disclosure of extent of compliance*

As with any assertion the auditor must consider whether assertions made in the notes with respect to the extent of such compliance are factually correct and not misleading. If disclosures are misleading, the auditor's report expresses a qualified or adverse opinion, unless the comment on compliance is removed.

(b) Implications for the auditor's report

(i) *Non-compliance with IAS 38*

According to IAS 1 'Presentation of Financial Statements', 'fair presentation' requires that financial statements should *not* be described as complying with IFRSs unless they comply with *all* the requirements of each applicable:
- standard; AND
- IFRIC interpretation.

IAS 38 'Intangible Assets' requires that development costs which meet all the specific criteria (e.g. technical feasibility) for asset recognition MUST be recognised as an asset and not expensed.

Tutorial note: *The question does not call for the regurgitation of those criteria.*

Total development costs expensed during the year represent 45% of reported profit before tax and are therefore material.

The Shs.1·4 million which should have been capitalised represents:
- 1·3% of total assets;
- 38% of development costs incurred during the year; and
- 17% of PBT.

Although clearly material to PBT it is not particularly material to the balance sheet. However, this is only the amount which should be capitalised for the current year. If not adjusted for this year, it would be an unadjusted error, the cumulative effect of which should be considered in the subsequent year.

Therefore, as there is clearly non-compliance, which is material, the financial statements do *not* comply with IFRS.

Management should be asked to:

- increase intangible non-current assets by Shs.1·4 million;
- reduce development expenses by Shs.1·4 million (thereby increasing profit to Shs.9·6 million);
- change the accounting policy note for development costs to state that an asset is recognized when certain criteria are met.

In the absence of which the audit opinion should be qualified 'except for' disagreement – unless the assertion of compliance with IFRS is deleted.

Tutorial notes:
(1) As there is no reason to suppose that the prior year policy was other than to expense as incurred, there is no brought forward balance and IAS 38 transitional provisions are not retrospective.
(2) If, having capitalised the intangible asset, it is apparent that it is impaired, an appropriate impairment loss should be recognised (even 100%).

(ii) *Reporting on the Internet*

- The auditor's duty of care is not extended solely by virtue of the report being published in an electronic form as well as hard copy (i.e. manually signed financial statements).

Tutorial note: *Although some commentators may argue contrary to this, this is what is asserted by recently issued guidance (e.g. by IFAC, in UK, Australian AGS, etc).*

- The directors are primarily responsible for web-published financial statements (e.g. signing them). Management should have an internet reporting policy to ensure the same integrity of financial information as that published in traditional (i.e. paper) form.
- Frazil's management should be in discussion with the auditors to agree the extent to which audited information will be included on the website (rather than 'informing' that the annual report is to be so published).
- Audit procedures to check the information being presented electronically should include:
  - reviewing the process by which the financial statements to be put on the web are derived from the financial information contained in the manually signed financial statements (e.g. by conversion to PDF or HTML format);
  - proofing the content of the electronic version against the hard copy;
  - confirming that the auditor's signature copied into an electronic medium is protected from modification;
  - checking that the conversion has not distorted the overall presentation of the financial information.
- It will be particularly important that it should be clear to all users of the financial information available from the website which information has been audited and which has not. (Identification of what has been reported on with page numbers is possible with pdf format, but there are no page numbers for html presentation of annual reports.) All hyperlinks in and out of the audited financial statements should be 'flagged' (e.g. through a 'secure site' entering/leaving notification).
- If the auditor's report on the hardcopy financial statements refers to page numbers which are not supported by the web-based version it will require amendment.
- Management's responsibility for implementing an appropriate security infrastructure should be acknowledged in the management representation letter. This should

encompass control procedures to reduce, as far as possible, the risk that changes are not properly authorised, and ensure that all changes can be detected and monitored.

Tutorial note: *Management's responsibilities are not diminished when the enterprise uses a third party to maintain its website – even though the maintenance of the website has been put in the hands of a third party, management cannot 'outsource' its responsibilities.*